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IN THE

# Supreme Court of the United States

October Term, 1995

MARNIE FERNANDEZ,
EXECUTRIX OF THE ESTATE OF BEVERLY POSTON,
and
DONALD RUTHERFORD,

*Petitioners*

v.

GEORGE W. EMERSON, JR.,
TRUSTEE,
and
RAY MAPLES AND BRENDA MAPLES,

*Respondents*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

In this bankruptcy case, the debtor obtained Petitioners' funds by fraudulently representing himself as being an agent for a legitimate mutual fund. The debtor feloniously converted Petitioners' money by giving it to investors in his Ponzi scheme. Petitioners definitively traced their specific funds into the debtor's bank account and then into the possession of the transferees, who also had been sued by the bankruptcy trustee seeking to avoid the transfers.

The Questions Presented are:

1. In a Chapter 7 bankruptcy case, is money--that is stolen, converted, or fraudulently obtained by the debtor and then transferred to third parties--"property of the estate" and thus recoverable only by the bankruptcy trustee or does this money--to the extent it is traceable--remain property of the rightful owners and recoverable by them from the third parties?

2. Do bankruptcy policy considerations which favor equality of distribution among creditors defeat the right of a debtor's fraud victims to recover their property when they have precisely identified and traced their money and where it is undisputed that the debtor--pre-petition--had no right to use their funds to pay his debts?

## PARTIES TO THE PROCEEDINGS

The parties to the proceedings, including those listed in the caption, are:

*Petitioners*

Marnie Fernandez, Executrix of the Estate of Beverly Poston, Intervenor below,

Donald Rutherford, Intervenor below,

*Respondents*

George W. Emerson, Jr., Trustee of the bankruptcy estate of Mark Benskin & Co. Inc. (involuntary Chapter 7 proceeding), Plaintiff below, and

Ray Maples and Brenda Maples, Defendants below in avoidance proceeding initiated by the Trustee.

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# PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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## PETITION FOR A WRIT OF CERTIORARI

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Petitioners MARNIE FERNANDEZ, Executrix of the Estate of Beverly Poston, and DONALD RUTHERFORD respectfully petition for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this case on June 26, 1995.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit is unreported and is reprinted in the appendix to this

Petition ("App.") at App. 3a-App. 18a. The orders of the United States District Court for the Western District of Tennessee affirming the Bankruptcy Court's judgments are unreported and are reprinted in the appendix at App. 19a-App. 26a and App. 27a-App. 34a. The opinion and judgment of the United States Bankruptcy Court for the Western District of Tennessee is reported at 161 B.R. 644 (Bankr.W.D.Tenn. 1993) and reprinted in the appendix at App 35a-App. 62a (and see App. 63a-App. 67a).

## GROUNDS FOR JURISDICTION

Respondent, George W. Emerson, Jr., initiated this case by filing an adversary proceeding, as bankruptcy trustee, against Respondents Ray and Brenda Maples pursuant to 11 U.S.C. §548 (fraudulent transfer) in the United States Bankruptcy Court for the Western District of Tennessee. Beverly Poston (now deceased and substituted by her daughter, Petitioner Marnie Fernandez, Executrix of the Estate of Beverly Poston) was allowed to intervene. Respondent Emerson also filed an adversary proceeding against Donald and Katherine Hollie pursuant to 11 U.S.C. §547 (preference) and §548 (fraudulent transfer).[1] Petitioner Donald Rutherford was allowed to intervene in that case.

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §157. In each case, the bankruptcy court issued opinions and judgments in favor of the trustee, December 7, 1993 [Poston (later Fernandez)] [App. 35a-App. 62a] and December 8, 1993 (Rutherford). [App. 63a-67a].

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[1] The Hollies were dismissed from the case when they essentially interplead the funds received from the debtor. Those funds remain in a separate account pending the outcome of this appeal.

Petitioners filed a timely notice of appeal to the United States District Court for the Western District of Tennessee on December 13, 1993. The District Court had jurisdiction pursuant to 28 U.S.C. §158. On February 22, 1994, the District Court issued orders in both cases affirming the judgments of the bankruptcy court. [App. 19a-App. 26a and App. 27a-App. 34a].

On February 25, 1994, Petitioners filed a timely notice of appeal to the Court of Appeals for the Sixth Circuit. Jurisdiction was based on 28 U.S.C. §158(d). The cases were consolidated on appeal.

On June 26, 1995, the Court of Appeals affirmed. [App. 3a-App. 18a]. A timely petition for rehearing, with suggestion for rehearing en banc, was denied on August 4, 1995. [App. 1a-App. 2a].

The jurisdiction of this Court to review the judgment of the Sixth Circuit is invoked under 28 U.S.C. §1254(1). Pursuant to Supreme Court Rule 13.1 and 13.3, this Petition is filed within 90 days of the denial by the Court of Appeals of Petitioners' timely petition for rehearing.

## STATUTES OR PROVISIONS INVOLVED

[pertinent portions only noted]

**11 U.S.C. §541(d):**

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest,...becomes property of the estate...only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

**11 U.S.C. §548:**

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

## STATEMENT OF THE CASE

In this Chapter 7 bankruptcy case, the debtor, Mark Benskin & Co., Inc.,[2] established an insurance brokerage and investment business in 1986. The debtor eventually began operating the business as a "Ponzi" scheme, by paying earlier investors fictitious "profits" with funds received from later investors.

In November, 1988, an elderly woman, Beverly Poston,[3] deposited two cashier's checks totaling $137,150.34 with the debtor who was to immediately transfer her funds to the American Capital Fund--a legitimate mutual fund--where a joint account for her and her daughter was to be established. Instead, however, the debtor deposited Poston's funds into his escrow checking account and transferred, by several checks, $33,100 *of Poston's funds*, to Respondents Ray and Brenda Maples. The debtor issued to Poston written statements--falsely representing--that he had deposited her funds into an account at American Capital as she had instructed. Poston was unaware until much later that her funds had been converted and transferred by the debtor.

On March 28, 1989, Petitioner Donald Rutherford deposited $50,000--the vast majority of his life's savings--with the debtor who was to immediately transfer Rutherford's funds to American Capital where an investment account would be established in his name. Instead, the debtor deposited

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[2] Mark Benskin operated his business as a sole proprietorship and ignored corporate formalities.

[3] During the course of these proceedings, Beverly Poston died. Petitioner, Marnie Fernandez, Poston's daughter and Executrix of the Estate of Beverly Poston was duly substituted.

Rutherford's $50,000 into the debtor's escrow checking account. *The next day*, the debtor transferred, by check, all of Rutherford's funds to Donald and Katherine Hollie, as part of a larger payment to them, also as a supposed "return" for their "investment" with him. It was uncontroverted that the debtor's check to the Hollies would have "bounced" had it not been for the deposit of Petitioner Rutherford's $50,000 into the debtor's escrow account. As he did with Poston and others who were ensnared by his scheme, the debtor issued to Rutherford written statements--falsely stating that he had deposited Rutherford's funds into an account at American Capital.

The debtor would later describe his activities as "robbing Peter to pay Paul." It was, in fact, precisely that.

The debtor turned himself in to the F.B.I. in early April, 1989.[4] He pled guilty to mail fraud and securities fraud related to his misappropriation of the funds belonging to investors, including both Petitioners. The debtor currently is in federal prison serving a ten year sentence for "stealing" Petitioner's funds and the funds of 48 other individuals named as victims in the indictment.

On April 14, 1989, an involuntary Chapter 7 bankruptcy petition was filed against the debtor's "company," Mark Benskin

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[4] The debtor gave a confession to F.B.I. agents and was later indicted by a federal grand jury and pled guilty to a fifty count indictment for mail fraud (18 U.S.C. §§ 2 and 1341) and securities fraud (15 U.S.C. § 77q(a) and 77x). The Court of Appeals for the Sixth Circuit affirmed the debtor's ten year sentence. *United States of America v. Benskin*, 926 F.2d 562 (6th Cir. 1991). The Court of Appeals found:

> In a further effort to conceal the fraud, Benskin issued checks (to quell any investor suspicion) to investors that requested a portion of their purported investment profits; Benskin often used money misappropriated from later investors to fund these payments. *Id.*, p. 563.

& Co., Inc. A trustee (Respondent Emerson) was appointed, and he filed numerous avoidance complaints, including these two cases against Respondents-defendants Ray and Brenda Maples and against defendants Donald and Katherine Hollie. The trustee sought to recover, as fraudulent transfers, all of the funds given to these individuals by the debtor. Petitioners Fernandez and Rutherford intervened in the respective adversary cases. They had traced their funds, which only recently had been misappropriated by the debtor, to the possession of the same defendants who the trustee sued.

In the proceedings regarding the Hollies and involving Petitioner Rutherford, the bankruptcy court granted Rutherford's motion for summary judgment, stating:

> This Court sitting as a court of equity, is convinced that to deny Mr. Rutherford recovery of the funds he has traced to the Hollies would result in a *"blatant and manifest injustice"* and would permit unjust enrichment. (emphasis added). [App. 84a].

A year later, after various other motions were filed, the bankruptcy court reversed itself and entered a judgment--after a trial--in favor of the trustee. The court held that the trustee had a superior right over Petitioner Rutherford to recover the debtor's entire payment to the Hollies, which in part included Petitioner's $50,000 acquired by the debtor's fraud. [App. 66a-App. 67a].

During the trials in both of these cases, the underlying facts were not in dispute. The debtor conceded he did not have the Petitioners' permission "to steal" their money. The trustee, Respondent Emerson, admitted that the debtor obtained Petitioners' funds by fraud or theft. The trustee admitted that the debtor *"embezzled, stole and/or unlawfully converted [Petitioner Rutherford's] funds."*

The following facts were admitted by the trustee (see F.R.Cv.P. Rule 36):

- The debtor did not have [Petitioners'] permission or consent to use [Petitioners'] funds to pay profits or settle accounts with the debtor's clients.

- The debtor did not inform [Petitioners] nor did he have [Petitioners'] consent or permission to use [Petitioners'] funds to pay the debtor's expenses and/or debts.

- The debtor did not have [Petitioners'] permission or consent to use [Petitioners'] funds for purposes unrelated to the investment of their funds.

- The credits created by the deposit of [Petitioner (Fernandez's)] checks on November 17, 1988 in the debtor's escrow account at the National Bank of Commerce were used to pay checks 1455, 1456, 1457 and 1458 issued to Ray and Brenda Maples totaling $33,100.

- The credits created by the deposit of [Petitioner Rutherford's] $50,000 check in the debtor's escrow account at the National Bank of Commerce were used to pay check number 1636 issued to Donald and Katherine Hollie.

Because the debtor deposited Petitioners' funds into a commingled checking account, a "first-in-first-out" tracing method was used by Petitioners' expert witness--an accountant who specialized in bank audits and accounting--to identify their funds. The first-in-first-out tracing methodology has been approved by the Sixth Circuit as an appropriate method to trace funds deposited into a commingled account. *U.S. v.*

*Intercontinental Industries, Inc.*, 635 F.2d 1215, 1220 (6th Cir. 1980). Likewise, the Ninth Circuit, in bankruptcy cases involving fraudulent transfers, has held that the first-in-first-out tracing methodology is the only tracing rule consistent with the purpose of the bankruptcy code. *In re California Trade Technical Schools, Inc*, 923 F.2d 641 (9th Cir. 1991).

Petitioners' uncontroverted evidence demonstrated that they had traced $33,100 of Poston's funds to four checks issued by the debtor to Respondents Ray and Brenda Maples on December 2, 1988. Similarly, Petitioner Rutherford's $50,000 was traced to the check issued by the debtor to the Hollie defendants on March 29, 1989 totalling $65,569.53. *There was no evidence offered in either case to rebut the Petitioners' tracing of their funds.*

Although the bankruptcy court recognized that the debtor acted in a "fiduciary capacity" as to Petitioners' funds [see, e.g., App. 48a], the court, nevertheless, issued a judgment in favor of the trustee.

On appeal, the district court, in affirming the bankruptcy court's judgment, held that §548 only requires the debtor to have an "interest" in the property transferred, "[t]he debtor is not required to have a legal or equitable interest in the property." [App. 24a; App 33a]. The district court rejected Petitioners' contention that the debtor could not have a superior interest over them in the funds he stole, converted, or obtained by fraud from them. [App. 22a-App. 25a; App. 32a-App. 34a].

On further appeal by Petitioners, the Court of Appeals for the Sixth Circuit affirmed the bankruptcy court's judgment in favor of the trustee. The Sixth Circuit held:

> the bankruptcy trustee could avoid the fraudulent transfers to the Maples and the Hollies and that the trustee's right to these funds was superior to that of the [appellants]. Finding that all of [the debtor's] investors should be treated equally, as unsecured creditors, furthers the goals of the Bankruptcy Code by allowing an equitable system of distribution. [App. 17a].

## REASONS FOR GRANTING WRIT

### SUMMARY

In holding that Petitioners' funds--obtained by the debtor's fraud--are property of the bankruptcy estate and are not recoverable by Petitioners, even though they clearly traced their funds into the possession of the same third parties who the trustee had sued, the Sixth Circuit has rendered a decision that not only conflicts with fundamental principles of property law and bankruptcy law, but also conflicts with the decisions of this Court.

Over seventy years ago, this Court in the original "Ponzi" case held that the victims of Ponzi's fraud had two remedies available to them to make them "whole": one was to follow their money to wherever they could trace it and assert possession of it, or two, they could assert a lien on a particular fund into which their money had been made a part. "These things they could do without violating any statutory rule against preference in bankruptcy, because they then would have been endeavoring to get their own money, and not money in the estate of the bankrupt." *Cunningham v. Brown*, 265 U.S. 1, 11 (1924).

Recently, in *Begier v. I.R.S.*, 496 U.S. 53, 58 (1990), this Court explained the purpose of the "avoidance provisions" of the

Bankruptcy Code; "if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated."

It is axiomatic that a person whose property is stolen or taken from him by fraud may recover his property wherever he can trace it. The fact that the "property" was money obtained by a debtor's pre-petition fraud should not alter this result.

The Sixth Circuit's decision allows a debtor to fraudulently obtain money, then file bankruptcy and the rightful owners of the money will be denied possession of it--even though they can specifically identify it as their property. Thus, the victims of a debtor's theft or fraud *will always be relegated to the status of unsecured creditors, regardless of their ability to identify their property or trace their money*. Such a result is a manifest injustice that surely will encourage fraudulent and criminal conduct by the unscrupulous who then will seek sanctuary in the bankruptcy courts.

The Sixth Circuit's decision has altered well settled bankruptcy law by allowing money obtained by a debtor's fraud, which has been traced by the owners, to be included as "property of the estate" for distribution to creditors. This issue is of exceptional importance and will recur in countless cases. Because bankruptcy filings continue to increase substantially each year and this decision is contrary to fundamental principles of property law and bankruptcy law, the attention of this Court is needed.

## I. THERE IS A NEED FOR UNIFORMITY ON FUNDAMENTAL ISSUES OF FEDERAL BANKRUPTCY LAW

One of the primary purposes of the Court's certiorari jurisdiction is to ensure uniformity of decisions among the courts of appeals, particularly on an issue of federal law. *See, e.g., Arco Corp. v. Aero Lodge 735*, 390 U.S. 557, 559 (1968); *Northwestern National Bank v. U.S.*, 387 U.S. 213, 217 (1967); *Magnum Import Co. v. Coty*, 262 U.S. 159, 163 (1922). The issues presented in this case not only involve square conflicts with well settled precedent established by this Court, but also with decisions in the other Circuits.

This Court as well as the Courts of Appeals for the Fifth, *Sixth*, Seventh, Eighth, Tenth and Eleventh Circuits all have held that property obtained by the debtor's fraud *is not part of the bankruptcy estate*—the bankruptcy estate simply does not include property of others held by the debtor. *Cunningham v. Brown*, 265 U.S. 1, 11 (1924); *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 135 (1962); *United States v. Whiting Pools*, 462 US. 198, 204 n. 8 (1983); *Begier v. I.R.S.*, 496 U.S. 53 (1990); *In re Quality Holstein Leasing*, 752 F.2d 1009 (5th Cir. 1985); *First Federal of Michigan v. Barrow*, 878 F.2d 912, 916 (6th Cir. 1989); *In re Teltronics, Inc.*, 649 F.2d 1236, 1239 (7th Cir. 1981); *Nicklaus v. Bank of Russellville*, 336 F.2d 144, 146 (8th Cir. 1964); *In re Mahan & Rowsey, Inc.*, 817 F.2d 682, 684 (10th Cir. 1987), and *In re General Coffee Corp.*, 828 F.2d 699 (11th Cir. 1987).

*In re Teltronics, Inc.*, the Seventh Circuit reaffirmed the oft cited rule that "property obtained by fraud is not part of the bankrupt's estate represents the policy that property should remain in the hands of its rightful owners, no matter how legitimate the claims of creditors." *Id.*, p. 1239.

In *Nicklaus*, the Court held that "a Trustee in Bankruptcy can have no interest in property acquired by the fraud of a bankrupt, or anyone else as against the claim of the rightful owner of such property." *Id.*, p. 146.

Recently, the Tenth Circuit, in a bankruptcy case involving a Ponzi scheme, held that a recipient of property obtained by fraud does not acquire "title" to such property. *In re M & L Business Machine Company, Inc.*, 59 F.3d 1078, 1081 (10th Cir. 1995) the court concluded:

> [W]here fraudulently obtained assets are held by the debtor but are readily distinguishable from assets to which general creditors have a claim, *it is proper to return the property to the defrauded party rather than distribute it through the estate*, which of course seeks to distribute assets equitably among all creditors or as many as possible. In a Ponzi scheme, or other scenario where creditors are almost exclusively defrauded parties, there is no distinguishing characteristic which promotes the interests of one over another. Consequently, *absent direct identification of the defrauded funds*, it is to the detriment of all other similarly situated creditors to favor one defrauded party over another. *Id.*

It is undisputed that Petitioners, through meticulous, accurate and expert tracing of their funds into and through debtor's bank account, *did directly* identify their funds stolen from them by the debtor. As such, they were entitled to recover those traced funds.

Also recently, the Seventh Circuit, in *Scholes v. Lehmann*, 56 F.3d 750, 759 (7th Cir. 1995), held that a receiver for corporations owned by a principal in a Ponzi scheme had standing to recover funds transferred by the corporations to others

(including religious groups). Recovered funds were then distributed to the victims of the Ponzi scheme. The Seventh Circuit explained:

> A thief rushes into a church, and, unobserved by anyone, drops the money he has stolen from his victim into the collection plate. Does the church obtain good title as against the thief's victim? It does not. The case is only slightly more difficult if the "thief" obtained the money by fraud rather than by larceny. A theft cannot pass good title; most frauds can. (citation omitted). The fraudulent conveyance statute, however, would enable the owner to set aside the transfer to the church and recover the money. We do not think anyone would quarrel with this result. *Id.*

The Seventh Circuit has also held that possession of property by the debtor, who lacks beneficial title, does not make the property part of the debtor's bankruptcy estate. *In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988).

Likewise, the Eleventh Circuit has held that funds passing through the possession of the debtor do not automatically become property of the estate. *In re Chase & Sanborn Corp.*, 813 F.2d. 1177 (11th Cir. 1987). Other Circuits also have recognized the principle that the recipient of property obtained by fraud does not acquire title to it. *See, e.g. In re Paragon Securities Company*, 589 F.2d 1240 (3rd Cir. 1978); *In re North American Coin & Currency, Ltd.*, 767 F.2d 1573 (9th Cir. 1985).

Even the Sixth Circuit, in a different context in a bankruptcy case, held that an agent's possession of funds does not mean that the agent owned the funds. In *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712 (1992), the court found

that an agent's possession of funds owned by his principal remained the property of the principal even though "as a matter of raw power," the agent could have violated his instructions and taken the cash to a race track or a jewelry store. *Id.*, p. 722. Without question, the debtor violated the instructions of his principals, the Petitioners. The debtor's violations of the Petitioners' instructions should not deprive Petitioners of their property. Nor should a debtor's mere possession of property--regardless of how it was obtained--make it an asset of the bankruptcy estate.

Granting this Petition is advisable, not only due to the importance of the issue, its recurring character, and the need to secure conformity to this Court's precedence, but also due to the conflict in the Circuits.

## II. THERE IS A NEED FOR THIS COURT'S INTERPRETATION OF THE TERM "PROPERTY OF THE DEBTOR"

In *Begier v. I.R.S., supra*, 496 U.S. 53 (1990), at 496 U.S. at 58, this Court noted that the Bankruptcy Code does not precisely define "property of the debtor." However, "property of the debtor" was held by the Court not to include property of the debtor *held in trust for another.*

> The Bankruptcy Code does not define "property of the debtor." Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate—the property available for distribution to creditors—"property of the debtor" subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings.

* * * * *

**Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not "property of the estate."**

The *Begier* Court rejected a trustee's attempt to recover payments made to the IRS. The Court held that funds withheld from employees' checks and paid--pre-petition--to the IRS were not preferences even though the debtor had not segregated the funds in a separate account. *Id.*, p. 57. The Court held the payments made from the debtor's general accounts were not "property of the debtor", but "were instead property held in trust for the Government..." *Id.*, p. 67.

The Sixth Circuit recognized that the Bankruptcy Court found the debtor had acted in a fiduciary capacity as to Petitioners' funds. Yet it ignored the uncontradicted evidence that the debtor simply had possession of Petitioners' funds for the sole purpose of delivery to American Capital. He had no authority to use them for any other purpose. For example, he could not use them to pay his expenses or debts, or to settle accounts with other clients. Petitioners' funds would not have been available for distribution to creditors because the debtor had no authority prior to bankruptcy to use those funds in any such way.

The fundamental rule of bankruptcy was explained by this Court in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 135-136 (1962)--the bankrupt's estate does not include funds not owned by a debtor when the bankruptcy petition is filed. "The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors." *Id.*

Petitioners complied with all requirements established by this Court regarding the tracing of their funds and established their entitlement to possession of their property. In affirming the District Court's denial of relief to these Petitioners, the Sixth Circuit directly contravened these principles. Its decision has expanded a debtor's estate to include property a debtor obtains by fraud even if the victims of the debtor's fraud identify and trace their property.

## III. THE SIXTH CIRCUIT DECISION CONTRAVENES PREVIOUS SIXTH CIRCUIT OPINIONS

The Sixth Circuit's decision also failed to follow other Sixth Circuit opinions related to this matter. For example, the Sixth Circuit previously had ruled, in a different context in a bankruptcy case, that an agent's possession of funds does not mean the agent owned the funds. *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712 (6th Cir. 1992), the Court found that an agent's possession of funds owned by his principal remained the property of the principal even though "as a matter of raw power," the agent could have violated his instructions and taken the cash to a race track or a jewelry store. *Id.*, p. 722.

The present decision also conflicts with Sixth Circuit opinions of *McLemore v. Third National Bank in Nashville (In re Montgomery)*, 983 F.2d 1389, 1393 (6th Cir. 1993) and of *First Federal of Michigan v. Barrow*, 878 F.2d 912, 916 (6th 1989). Iterating the law of the Sixth Circuit, both cases quoted with approval *Morris Plan Industrial Bank of New York v. Schorn*, 135 F.2d 538, 539 (2nd Cir. 1943):

> [It is a] well settled rule that property converted, embezzled, or otherwise taken by the bankrupt, or *obtained by him by fraud*, can be claimed from the bankrupt estate [as] long as it can be definitively traced... (emphasis added).

The Sixth Circuit in its present opinion relied upon a recent decision, *In re Omegas Group, Inc. (X/L Datacomp, Inc. v. Wilson)*, 16 F.3d 1443 (6th Cir. 1984), which held a bankruptcy court cannot, post-petition, take property out of an estate by declaring a constructive trust on that property when, pre-petition, the property was not previously held in trust. However, such a rule does not apply where, as here: the debtor, pre-petition received and held funds in a fiduciary capacity, the property is not in the possession of the estate but is in the possession of third parties, and where the bankruptcy estate along with the rightful owners have asserted claims to the same property.

The Sixth Circuit decision also is in conflict with the evidence. In an attempt to elevate bankruptcy policy considerations above the Bankruptcy Code in order to allow the trustee to recover property for the bankruptcy estate, the Sixth Circuit side-stepped the plain fact that Petitioners *were able* to directly trace their stolen funds to the transfers at issue. The Sixth Circuit sought to minimize Petitioners' "first-in--first-out" tracing method. Yet there was no other proof or method offered to contravene that approach.

Further, the Sixth Circuit failed to recognize that the "first-in-first-out" rule for tracing funds has been relied on by Tennessee courts to sort and trace payouts from a commingled account and to trace misappropriated funds. See *Brochus v. Morgan*, 33 Tenn. Cases 667 (1875); *State ex rel. Robertson v.*

*Bank of Bristol*, 165 Tenn. 461, 55 S.W.2d 771 (1933); *State ex rel. Robertson v. Thomas W. Wrenne & Co.*, 170 Tenn. 131, 92 S.W.2d 416 (1936), and *First American National Bank of Nashville v. Commerce Union Bank of White County*, 692 S.W.2d 642 (Tenn. App. 1985). The "first-in-first-out" rule also is utilized by the Uniform Commercial Code to sort credits and withdrawals in a commingled account. Tenn. Code Ann. §§47-4-208(2) and 47-4A-504.

By the present decision, a person may obtain property by fraud, feloniously convert it, give it to third parties, file bankruptcy, and the rightful owners will be deprived of their unquestionable right to recover their property. Only a bankruptcy trustee can recover the property--so as to distribute it among the creditors of the estate. Thus, as Petitioners have noted, the victims of the debtor's fraud will always be relegated to the status of unsecured creditors even if they definitively identify and trace their property. The Sixth Circuit's decision is plainly wrong and in effect compounds the injustice suffered by Petitioners.

## IV. CONFLICT WITH TENNESSEE LAW

Finally, the Sixth Circuit misapprehended Tennessee law by concluding the debtor's acquisition of Petitioner's funds was not a "theft" and thus he supposedly had acquired a voidable or defeasible title in the funds--sufficient to satisfy certain requirements of the Bankruptcy Code as to fraudulent transfers. The Sixth Circuit examined Tennessee's criminal statutes defining fraud as "deceit, trickery, misrepresentation, and subterfuge." (Tenn. Code Ann. §39-11-106(13)). It noted a person commits "theft" if "with intent to deprive the owner of property, the person knowingly obtains or exercises control over the property without the owner's effective consent." (Tenn. Code Ann. §39-14-103).

The Sixth Circuit concluded: "[w]ith theft, the owner has no intention to part with his property, but in the case of fraud, the owner willingly entrusts his property into the hands of another for some purpose, unaware he is being deceived." Thus, "[a] person who steals property never divests the owner of title to his property and the owner can follow and reclaim the stolen goods wherever he may find them." However, a person who obtains property by fraud acquires voidable title to property and pursuant to Tennessee law can transfer good title to a good faith purchaser for value. (Tenn. Code Ann. §47-2-403).

These conclusions are erroneous for two reasons. First, neither of the transferees were good faith purchasers for value. The Bankruptcy Court correctly noted that they did not give any value for the transfers received from the debtor. [See, e.g., App. 54a; App 65a]. Thus, the panel's analysis of void versus voidable title is irrelevant.

The relevant relationship to examine is between the perpetrator and the owner. Unquestionably, as between the perpetrator and the owner, the perpetrator obtains no greater interest in the property depending upon whether he steals it or obtains it by fraud, in either case he only acquires possession—albeit unlawful possession. Therefore, under Tennessee law the perpetrator can have no greater interest in the property than the owner. No case has ever held that a thief or a perpetrator of a fraud obtained a greater interest in the property than the owner.

Second, Tennessee has adopted a "generic" offense of theft. (Tenn. Code Ann. §39-14-101, Sentencing Commission

Comments).[5] "Conduct denominated as theft... constitutes a single offense embracing the separate offenses heretofore known as: embezzlement, false pretense, fraudulent conversion, larceny, receiving and concealing stolen property, and other similar offenses." (Tenn. Code Ann. §39-14-101). Accordingly, a person commits a *theft* by obtaining property by fraud, by larceny or by embezzlement. Thus, there is no "subtle" difference under Tennessee law as to a thief's interest in property stolen by any of these forms. In all cases of theft, the thief has no interest in the stolen property he can pass, even to bona fide purchasers for value. *Butler v. Buick Motor Co.*, 813 S.W.2d 454, 458 (Tenn. App. 1991), *cert. denied.* Therefore, under Tennessee law, Benskin's acquisition and subsequent transfer of Petitioners' was a theft.

In *Butler*, a case relied on by the Sixth Circuit, an automobile had been entrusted to an employee, who converted it and disposed of it an unauthorized manner. The court concluded this subsequent disposition of the vehicle was a theft, therefore, he could not pass any title—not even voidable title—to a bona fide purchaser for value. *Id.*, p. 458. The court found the employee had no authority to dispose of the vehicle in the way he did. The court said the rule long applied in Tennessee was well stated in 63 Am.Jur.2d *Property* §44:

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[5] Even before Tennessee's adoption of a generic definition of theft, Tennessee courts had broadly defined the word to include all forms of wrongful taking of property of another. "The word 'theft' is not like the word 'larceny', a technical word of art with a narrowly defined meaning, but is on the contrary, a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker,..." *Dobyns-Taylor Hardware Co. v. U.S.*, 278 F.Supp. 538, 541-542 (E.D.Tenn. 1967).

> The theft of goods or chattels does not divest one who owns, or has title to, such property from his ownership of the property, the owner may follow and reclaim the stolen goods wherever he may find them, even if such goods have been changed or improved.

The debtor never had Petitioner's authority to give their money to the transferees. Unquestionably, the debtor committed a theft, and Petitioners therefore were entitled to recover their funds.

The Sixth Circuit's decision ignored well settled governing legal principles in denying relief to Petitioners. Petitioners respectfully request that this Court review this decision to correct the injustice that has been created and to clarify fundamental and recurring issues in bankruptcy law.

## CONCLUSION

For the foregoing reasons, this Court should grant the writ and reverse the decision below.

RESPECTFULLY SUBMITTED,

DAVID M. SULLIVAN
202 Adams Avenue
Memphis, Tennessee 38103
(901) 521-1028

*Attorney for Petitioners*

No. 95- _____

**IN THE**
**SUPREME COURT OF THE UNITED STATES**
**October Term, 1995**

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**MARNIE FERNANDEZ,**
**EXECUTRIX OF THE ESTATE OF BEVERLY POSTON,**
**and**
**DONALD RUTHERFORD,**

***Petitioners***

**v.**

**GEORGE W. EMERSON, JR.,**
**TRUSTEE,**
**and**
**RAY MAPLES AND BRENDA MAPLES,**

***Respondents***

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# PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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## APPENDIX TO PETITION

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Nos. 94-5421/5422

**UNITED STATES COURT OF APPEALS**
**FOR THE SIXTH CIRCUIT**

| | | |
|---|---|---|
| IN RE: MARK BENSKIN & COMPANY, INC., Debtor | * | Filed: August 4, 1995 |
| GEORGE W. EMERSON, JR., TRUSTEE, Plaintiff-Appellee, | * | |
| v. | * | ORDER |
| RAY MAPLES and BRENDA MAPLES, Defendants-Appellees, | * | |
| | * | |
| MARNIE FERNANDEZ, Executrix of the Estate of Beverly Poston, Intervening Defendant-Appellant (94-5421) | * | |
| DONALD RUTHERFORD, Intervening Defendant-Appellant (94-5422). | * | |

BEFORE: JONES and BATCHELDER, Circuit Judges, and JOINER, District Judge:

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*The Honorable Charles W. Joiner, United States District Judge for the Eastern District of Michigan, sitting by designation.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

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Leonard Green, Clerk

NOT RECOMMENDED FOR PUBLICATION
Nos. 94-5421/5422

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

| | | |
|---|---|---|
| IN RE: MARK BENSKIN & COMPANY, INC., Debtor | * | |
| | | FILED: JUNE 26, 1995 |
| GEORGE W. EMERSON, JR., TRUSTEE, Plaintiff-Appellee, | * | ON APPEAL FROM THE UNITED STATES |
| v. | * | DISTRICT COURT FOR THE |
| RAY MAPLES and BRENDA MAPLES, Defendants-Appellees, | * | WESTERN DISTRICT OF TENNESSEE |
| MARNIE FERNANDEZ, Executrix of the Estate of Beverly Poston, Intervening Defendant-Appellant (94-5421) | * | |
| DONALD RUTHERFORD, Intervening Defendant-Appellant (94-5422). | * | |

BEFORE: JONES and BATCHELDER, Circuit Judges, and JOINER, District Judge*:

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*The Honorable Charles W. Joiner, United States District Judge for the Eastern District of Michigan, sitting by designation.

PER CURIAM. Intervening Defendants Marnie Fernandez, executrix of the estate of Beverly Poston, and Donald Rutherford are appealing the bankruptcy court's and the district court's decisions to award the trustee of Mark Benskin & Company, Inc.'s estate, money that Benskin ("Debtor") fraudulently obtained from the intervenors in a classic Ponzi scheme.[1] Subsequently, Benskin paid the money to Ray and Brenda Maples and Donald and Catherine Hollie, who were also investors, shortly before involuntary bankruptcy petitions were filed against Benskin and his company. The intervenors contend that the lower courts erred in their determination that the trustee had a superior right to the funds in question. Moreover, the intervenors argue that the lower courts' refusal to grant the intervenors' motions for summary judgment was an abuse of discretion. We affirm the decisions of the lower courts.

I.

In 1986, Mark Benskin established an insurance brokerage and investment commodity business known as Mark

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[1] The financial scheme that Charles Ponzi utilized and the remarkable response by investors is reported in *Cunningham v. Brown*, 265 U.S. 1 (1924). It seems Ponzi borrowed from investors against only his personal 90-day notes, issued for 150% of the amount borrowed. Ponzi took in $9,582,000 in eight months. After a Boston newspaper published a report that Ponzi was hopelessly insolvent, investors demanded the return of their money. The defendants in the case obtained payment shortly before Ponzi's bankruptcy petition was filed. The lower courts accepted defendants' argument that they had rescinded for fraud and that payments to them merely represented a return of their own money. Disagreeing, the Supreme Court found the payments were preferences even if it assumed defendants had rescinded for fraud, because it was impossible for defendants to trace their funds. "It is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt[cy] law." *Id.* at 12-13.

Benskin & Company.[2] The main emphasis of the business was investments. Clients would invest money with Benskin in the hope of obtaining a good return on the investments Benskin promised to make on their behalf. Benskin invested his clients' money in the stock market and in mutual funds. He would then send his clients monthly reports reflecting any gains or losses on their money.

To operate his business, Benskin set up two bank accounts. One account was simply an "operating account" out of which Benskin paid company-related expenses such as rent and electricity. The second account was an "escrow account" at the National Bank of Commerce into which all client money was deposited and from which all investments were made. To pay for any stocks or securities purchased for his clients, Benskin transferred funds from the escrow account to general accounts in the name of Mark Benskin & Co., maintained at brokerage houses, Merrill Lynch and McClarty & Co., or to the general account Benskin maintained in a mutual fund that was known as American Capital. Further, to pay clients returns on their investments, Benskin distributed funds from this same escrow account. Benskin did not establish individualized client accounts at either of the brokerage houses or with the mutual fund.

Benskin testified, however, that he treated a limited number of "restricted" funds (such as IRA or Keough funds) differently by keeping those funds segregated and intact. With such restricted funds, Benskin established a separate account at American Capital in the name of the client. In all other transactions, Benskin deposited the client's money into the

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[2] The bankruptcy court found, and the parties did not dispute, that Benskin conducted his business as a sole proprietorship and ignored corporate formalities.

escrow account and subsequently transferred it to his general accounts at American Capital or the brokerage houses.

In the beginning, Benskin may have actually invested some of the unrestricted money as he had promised. At some point in 1987 however, Benskin began to create a shortfall in the escrow account due to his personal withdrawals. Furthermore, through false statements, Benskin promised fictitious profits to his clients. In order to fund the shortfall, Benskin decided to pay the old clients' profits with the new clients' money.

The number of Benskin's clients continued to increase until early 1989. At that time a run on the bank started as more and more clients began demanding larger amounts of money. In an effort to delay the inevitable discovery of his fraud, Benskin distributed all funds in his escrow account in early 1989. Due to the amount that he had previously disbursed to himself,[3] however, and the enormous profits he had promised, Benskin's scheme was discovered. Benskin was arrested in April 1989. He confessed to the F.B.I. and was later indicted by a federal grand jury and plead guilty to a fifty count indictment for mail fraud and securities fraud. This court affirmed Benskin's ten year sentence. *United States v. Benskin*, 926 F.2d 562 (6th Cir. 1991).

Shortly thereafter, on April 14, 1989, involuntary bankruptcy petitions for Mark Benskin individually, and Mark Benskin & Company, Inc., were filed. George Emerson was appointed trustee, and he filed adversary proceedings against all of Benskin's clients, who had withdrawn any money within the last ninety days, and against those clients, who had withdrawn

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[3] Alan Exelbierd, the accountant for the trustee, testified that in 1987 Benskin deposited $2,282,000 and disbursed $2,282,000, including $504,578.74 to himself, and in 1988 he deposited $1,992,902.38 and disbursed $1,914,775.03, including $519,422.27 to himself.

"profits" within the last year prior to the filing date.

Among those proceedings was the trustee's fraudulent conveyance action against Brenda and Ray Maples pursuant to 11 U.S.C. §548. According to Benskin's records, the Maples withdrew $53,100 in "profits" during the one-year period preceding the bankruptcy filing. So the trustee alleged that Maples received $53,100 in fraudulent transfers from Benskin. The Maples filed an answer denying that the funds were fraudulent transfers. Beverly Poston[4] intervened in this proceeding and filed a motion for summary judgment because she had deposited $137,150.34 with Benskin a few days before Benskin gave the Maples $33,100 in profits. Poston alleged that the Maples' profit payment was money that Benskin stole from Poston. *See Benskin*, 926 F.2d at 563 ("In a further effort to conceal the fraud, Benskin issued checks (to quell any investor suspicion) to investors that requested a portion of their purported investment profits; Benskin often used money misappropriated from later investors to fund these payments."). Poston testified that she told Benskin she wanted her money invested in treasury bills. Benskin stated that Poston did not tell him specifically how to invest her money.

The bankruptcy court did not rule immediately on Poston's summary judgment motion. Instead, the court held a trial on November 12, 1993, and at the conclusion of the proof, the bankruptcy court denied Poston's Motion for Summary Judgment in an oral ruling. J.A. at 78. Subsequently, the court issued a final opinion on December 7, 1993. The court ruled that the trustee was entitled to a judgment against the Maples in the

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[4] During the course of the proceedings Beverly Poston died. Marnie Fernandez, her daughter and executrix of the estate of Beverly Poston, was duly substituted.

amount of $53,100 plus interest, and the court also denied Poston's complaint against the Maples and the bankruptcy estate. Poston appealed and the district court affirmed the bankruptcy court's decision on February 22, 1994.

The trustee also brought an adversarial proceeding, pursuant to 11 U.S.C. §§ 547, 548 against Donald and Catherine Hollie. The complaint alleged that the Hollie's withdrew $65,509.53 in "profits" from Benskin either as a preference or a fraudulent transfer within ninety days prior to the filing of bankruptcy. The Hollies filed an answer denying that the funds were either a preference or a fraudulent transfer.

Donald Rutherford, another Benskin client, intervened in this action because Rutherford had deposited $50,000 with Benskin a few days before the Hollies' withdrawal of $65,569.63. Rutherford alleged that Benskin stole Rutherford's $50,000 and gave those stolen funds to the Hollies. As a result, Rutherford claimed that the trustee was not entitled to recover for the benefit of the bankruptcy estate the funds that Benskin stole from him and gave to the Hollies. Benskin stated that Rutherford did not tell him specifically how to invest his money. Rutherford testified that he told Benskin he wanted Benskin to deposit the funds in Rutherford's name with the American Capital Securities fund.

During the course of the proceedings, the Hollies were dismissed from the case when they essentially interpleaded $60,000 into an account with counsel for the trustee and Rutherford as joint trustees. This money remains in a separate account pending the outcome of this appeal.

Facing motions for summary judgment from both the trustee and Rutherford, the bankruptcy court granted Rutherford's motion for summary judgment and denied the trustee's motion. Thereafter, several motions were filed requesting the court to reconsider its decision. The bankruptcy court subsequently

withdrew its previously filed opinion and set the case for trial. After the trial on November 15, 1993, the bankruptcy court issued an opinion finding that the trustee had proven its case under 11 U.S.C. § 548 (fraudulent conveyance). The court also incorporated by reference its opinion in *Emerson v. Maples*, the related adversary proceeding, and adopted the legal conclusions and reasoning found in that opinion. Rutherford appealed to the district court, and the district court affirmed the bankruptcy court's decision.

The intervenors in *Maples* (No. 94-5421) and *Hollie* (No. 94-5422) are now appealing the adverse lower court decisions.

**II. Who has priority over the contested funds?**

In this case the trustee brought a fraudulent conveyance action against the Maples and the Hollies pursuant to 11 U.S.C. §548.[3] As a preliminary matter, the trustee's ability to force the

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[3] In pertinent part, section 548 reads as follows:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily–
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

Maples and the Hollies to reconvey the contested funds to the estate of the debtor hinges on the ability of the trustee to meet the requisites of section 548. The intervenors claim that "[t]he trustee failed to satisfy the statutory requirements to avoid the transfer of the stolen funds to defendants." Intervenors' Br. at 15. In each case, however, the Maples bankruptcy court found that the trustee's proof was sufficient under both the section 548(a)(1) requirement that Benskin had actual intent to defraud his creditors and under the section 548(a)(2) requirements that (A) Benskin received less than a reasonable equivalent value for such transfer, and (B) that he (i) was insolvent on the date the transfer was made, (ii) was engaged in a business with unreasonably small capital, or (iii) believed that he would incur debts that would be beyond his ability to pay. J.A. at 48-50, 74, 242-243, 254. The factual findings of the bankruptcy court will not be set aside unless they are "clearly erroneous." *Crocker v. Braid Elec. Co. (In re Arnold)*, 908 F.2d 52, 55 (6th Cir. 1990). The bankruptcy court's conclusions of law, however, are reviewed *de novo*. *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 499 (6th Cir. 1990).

We believe the district court correctly found, pursuant to section 548(a)(1), that when Benskin transferred funds to the

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> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a) (1988).

Maples and the Hollies, he made the transfers with the actual intent to hinder, delay, or defraud his present or future creditors. In determining whether the debtor has the requisite intent, this court looks to the circumstances surrounding the transaction. *United States v. Berman*, 884 F.2d 916, 921-22 (6th Cir. 1989). One of the circumstances that unequivocally evidences fraudulent intent is the debtor's pursuit of a classic Ponzi scheme. Since 1966, this court has found that the question of intent to defraud in a Ponzi scheme "'is not debatable.'" *Conroy v. Shott*, 363 F.2d 90, 92 (6th Cir.), *cert. denied*, 385 U.S. 969 (1966). Other courts have also noted that an intent to defraud can be inferred as a matter of law from the mere fact that the debtor was running a Ponzi scheme:

> One can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent in the eyes of the law, and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.

*In re Independent Clearing House Co.*, 77 B.R. 843, 860 (D.Utah 1987). Based on the facts presented at trial and the indictment to which Benskin pled guilty, the bankruptcy court had more than enough evidence to find that Benskin had the requisite intent to

defraud his investors.

The intervenors argue, however, that in transferring funds to the Hollies and the Maples, Benskin only had the intent to defraud the intervenors and not the other creditors in general. Intervenor's Br. at 23. Yet, even if this is true, such intent brings the transfer within the purview of section 548(a)(1). The trustee need only show that when the debtor made the transfer, he intended to defraud any entity to which he was indebted. 11 U.S.C. § 548(a)(1). Those persons, who invest on the eve of a Ponzi scheme's collapse, are entities to whom the debtor becomes indebted when they entrust their funds to him. Thus, if at the time Benskin made the transfers to earlier investors, like the Maples and the Hollies, he had the actual intent to defraud later investors, like Fernandez and Rutherford, then such transfers are fraudulent within the meaning of section 548(a)(1). *See Independent*, 77 B.R. at 860.[4]

Despite this evidence, the intervenors argue that because Benskin stole their funds and never had title to those funds, Benskin had no "interest" in the property that he could transfer, as required in section 548(a). Intervenors' Br. at 17. Without such a legal or equitable interest, they argue that the trustee could not avoid the transfers to the Hollies and the Maples and statutorily mandate the return of the stolen money to Benskin's estate.

The Bankruptcy Code does not define the phrase "interest of the debtor in property" as used in section 548, but the Supreme Court has noted that "[p]roperty interests are created and defined by state law. Unless some federal interest requires a

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[4] We also agree with the bankruptcy court that the trustee met his burden of proof under section 548(a)(2), but because of our holding pursuant to section 548(a)(1), we find it unnecessary to develop this analysis.

different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner v. United States*, 440 U.S. 48, 55 (1979).

Turning, therefore, to Tennessee law, we find that the fundamental error in the intervenors' argument is that they ignore the significant distinction between obtaining the funds by theft and obtaining them by fraud. Tennessee law defines "fraud" as "the term is used in normal parlance" and it "includes . . . deceit, trickery, misrepresentation, and subterfuge," Tenn. Code Ann. §39-11-106(13) (1991), and Tennessee law also states that a "person commits theft of property if, with intent to deprive the owner of property, the person knowingly obtains or exercises control over the property without the owner's effective consent," Tenn. Code Ann. §39-14-103 (1991). With theft, the owner has no intention to part with his property, but in the case of fraud, the owner willingly entrusts his property into the hands of another for some purpose, unaware that he is being deceived.

Under Tennessee law, this subtle difference effects the status of the perpetrator's interest in the property. A person that steals property never divests the owner of title to his property, and the owner can follow and reclaim the stolen goods wherever he may find them. *See Butler v. Buick Motor Co.*, 813 S.W.2d 454, 458 (Tenn. Ct. App.), *cert. denied*, 502 U.S. 911 (1991). Any subsequent purchasers of the stolen property simply receive void title because the thief had no title to pass. *Id.* A person that obtains property by fraud, however, acquires voidable title to the property, and pursuant to Tennessee law, can transfer a good title to a good faith purchaser for value. *Id.* at 457 (citing Tenn. Code Ann. §47-2-403). Thus, the perpetrator of fraud obtains some legally cognizable interest in the property under Tennessee law, a voidable or defeasible title.

We find that this legal interest under Tennessee law is sufficient to constitute an "interest of the debtor in property" for purposes of section 548(a). *See In re Int'l Loan Network, Inc.*, 160 B.R. 1, 11 (Bankr. D.D.C. 1993) (holding that debtor's interest in property, which defendants asserted was non-existent because obtained by fraud, successfully met the requirements of section 548 because debtor nonetheless had a legally recognized interest in the property, a defeasible title).

The remaining question is really no question at all: whether Benskin's conduct constituted fraud or theft of property. The facts clearly indicate that Benskin deceitfully persuaded the intervenors to give him money for him to invest on their behalf. This constitutes fraud under Tennessee law.

Thus, Benskin did have an interest in the property, which he fraudulently obtained, and the trustee definitively established his statutory right under section 548(a) to avoid Benskin's fraudulent conveyances to the Maples and the Hollies.

Despite the foregoing conclusion, the intervenors contend, based on two separate grounds, that their right to the contested funds is superior to that of the trustee. First, the intervenors claim that when they gave money to Benskin for investment purposes, they created an express trust, which trumps the bankruptcy trustee's right to the avoided transfers. Second, the intervenors argue that because of Benskin's fraud, a constructive trust in favor of the intervenors should be imposed on the funds that were invested with Benskin, thereby precluding their inclusion in the bankruptcy estate.

A. An Express Trust?

Regarding the existence of an express trust, the intervenors correctly claim that a "debtor that served prior to bankruptcy as trustee of an express trust generally has no right to the assets kept in trust, and the trustee in bankruptcy must fork

them over to the beneficiary." *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.)*, 16 F.3d 1443, 1449 (6th Cir. 1994); *see also United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.10 (1983) ("Congress plainly excluded [from the bankruptcy estate] property of others held by the debtor in trust at the time of the filing of the petition."); *id.* at 204 n.8. Thus, if the intervenors could establish that they created an express trust when they gave money to Benskin for investment purposes, the money would be excluded from the bankruptcy estate of Benskin.

The bankruptcy court found that no express trust existed between Benskin and the intervenors. Although the court found that Benskin was acting in a fiduciary capacity as to the intervenors when he persuaded them to place funds with him for investment, the court did not find this proof sufficient to establish that an express trust was created. Moreover, the court held that the major impediments to a conclusion that an express trust existed were that Benskin did not segregate the funds entrusted to him, that he did not treat the funds as trust property prior to the bankruptcy filing, and that the funds of the intervenors were depleted from the escrow account prior to the bankruptcy filing. As such, there existed no identifiable trust *res*. *See Kopsombut-Myint Buddhist Ctr. v. State Bd. of Equalization*, 728 S.W.2d 327, 333 (Tenn. Ct. App. 1986) (noting that existence of trust requires proof of three elements: (1) a trustee who holds the trust property and who is subject to equitable duties to deal with it for the benefit of another; (2) a beneficiary; and (3) identifiable trust property).

The intervenors claim, however, that they can trace and identify their funds by applying the "first in, first out" rule, normally utilized in inventory contexts, to the bank's internal check posting methodology. Using this method, the intervenors offered proof allegedly identifying $33,100 of Poston's money

that was wrongfully transferred to the Maples and $50,000 of Rutherford's money that was wrongfully transferred to the Hollies.

Assuming *arguendo* that the intervenors' tracing method is valid, we are still not persuaded that the intervenors intended to establish an express trust when they gave investment money to Benskin. Such a conclusion is a stretch, against which equity weighs, because "to allow [the intervenors] to trace beyond the depleted escrow funds and to compete with the Trustee would be to elevate the [intervenors'] claims above an avoidance recovery for all creditors and to allow [the intervenors] a better recovery than similarly defrauded creditors." J.A. at 60.

B. A Constructive Trust?

Regarding the imposition of a constructive trust in favor of the intervenors, this court's recent opinion in *In re Omegas Group* is dispositive. In *Omegas*, an aggrieved creditor argued that it was the beneficiary of a constructive trust, which was established by the debtor's pre-petition fraud, and that the funds held by Omegas should be turned over to the creditor rather than being incorporated into the bankruptcy estate. 16 F.3d at 1447. This court began its analysis by noting that "a constructive trust is not really a trust," but a "legal fiction, a common-law remedy in equity that may only exist by the grace of judicial action." *Id.* at 1449. Thus, this court stated that "a claim filed in bankruptcy court asserting rights to certain assets 'held' in 'constructive trust' for the claimant is nothing more than that: a claim. Unless a court has already impressed a constructive trust upon certain assets or a legislature has created a specific statutory right to have particular kinds of funds held as if in trust, the claimant cannot properly represent to the bankruptcy court that he was, at the time of the commencement of the case, a beneficiary of a constructive trust held by the debtor." *Id.* (footnote omitted).

Based on this reasoning, this court held the following:

> We think that § 541(d) simply does not permit a claimant in the position of [the creditor] to persuade the bankruptcy court to impose the remedy of constructive trust for alleged fraud committed against it by the debtor in the course of their business dealings, and thus to take ahead of all creditors, and indeed, ahead of the trustee. Because a constructive trust, unlike an express trust, is a remedy, it does not exist until a plaintiff obtains a judicial decision finding him to be entitled to judgment "impressing" defendant's property or assets with a constructive trust. Therefore, a creditor's claim of entitlement to a constructive trust is not an "equitable interest" in the debtor's estate existing prepetition, excluded from the estate under § 541(d).

*Id.* at 1451.

Like the aggrieved creditor in *Omegas*, the intervenors in this case have nothing more than a "claim filed in bankruptcy court asserting rights to certain assets 'held' in 'constructive trust'" for them. They possess no pre-petition judgment from a court that impressed the investment funds with a constructive trust in their favor. Thus, they do not have an equitable interest that would exclude the funds from the bankruptcy estate.

In sum, we find the lower courts correctly held that the bankruptcy trustee could avoid the fraudulent transfers to the Maples and the Hollies, and that the trustee's right to these funds was superior to that of the intervenors. Finding that all of Benskin's investors should be treated equally, as unsecured creditors, furthers the goals of the Bankruptcy Code by allowing an equitable system of distribution.

## III.

Finally, we consider the intervenors' contentions that the bankruptcy court's refusal to grant their motions for summary

judgment was an abuse of discretion. *Pinney Dock & Transp. Co. v. Penn Cent. Corp.*, 838 F.2d 1445, 1472 (6th Cir.), *cert. denied*, 488 U.S. 880 (1988). After examining the arguments of the intervenors, the district court held that "[a]lthough different and novel interpretations of the events that occurred are possible in this instance, this Court believes the final order issued by the Bankruptcy Court is the correct conclusion of law and findings of fact." J.A. at 78, 258. Based on the foregoing analysis, we agree with the district court that the bankruptcy court did not abuse its discretion in denying the intervenors' motions for summary judgment.

## IV.

For the aforementioned reasons, we **AFFIRM** the decisions of the lower courts in both cases, No. 94-5421 and No. 94-5422.

**UNITED STATES DISTRICT COURT**
**WESTERN DISTRICT OF TENNESSEE**
**WESTERN DIVISION**

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**IN RE:** ]
]
**MARK BENSKIN & COMPANY**
] **FILED: FEBRUARY 22, 1994**
**GEORGE EMERSON, TRUSTEE**
]
**Plaintiff/Appellee,** ]
]
**v.** ] **Civil Action No. 94-2055 H**
]
**RAY AND BRENDA MAPLES,**
]
**Defendants/Cross-Defendants**
]
**and** ]
]
**MARNIE FERNANDEZ, as Executrix of the estate of Beverly Poston,**]
]
**Defendant/Intervenor/ Cross-Plaintiff/Appellant.**

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**ORDER AFFIRMING MEMORANDUM OPINION OF BANKRUPTCY COURT**

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This matter is an appeal of right by Marnie Fernandez from a judgment of the United States Bankruptcy Court for the Western District of Tennessee in an adversary case. The trustee brought this adversary proceeding against the Maples, pursuant

to 11 U.S.C. § 548. Mamie Fernandez is the defendant/intervenor/cross-plaintiff and appellant in this matter. This Court has jurisdiction pursuant to 28 U.S.C. § 158.

The issues presented for review by the appellant are as follows:

1. Whether the Bankruptcy Court erroneously concluded that the trustee of the bankruptcy estate has a superior right to that of the true owner to recover funds stolen from the true owner by the debtor and transferred by the debtor to a third party?

2. Whether the Bankruptcy's Court refusal to grant Ms. Poston's motion for summary judgment was an abuse of discretion?

## Statement of the Case

George Emerson ("trustee") brought this adversary proceeding against defendants Ray Maples and Brenda Maples seeking recovery of $53,100.00 transferred by several checks issued to them by Mark Benskin & Co., Inc. (hereinafter "Benskin"). The trustee sought to avoid the transfer under § 548 of the Bankruptcy Code [fraudulent transfer].

Beverly Poston was permitted to intervene as a defendant on January 7, 1992, and she filed an answer to the complaint from the trustee and a cross-complaint: against the Maples alleging the debtor had stolen $137,150.34 of her funds and had transferred $33,100.00 of those "stolen" funds to the Maples. Ms. Poston alleged the trustee was not entitled to recover those funds as part of the bankruptcy estate. Defendants Ray and Brenda Maples filed an answer to the complaint denying the allegations made by the trustee and Ms. Poston. The Maples contended that they should be allowed to keep the funds transferred to them by the debtor, although no specific legal theory was alleged in their cross complaint.

On 2 June 1992, Ms. Poston filed a motion for summary judgment in the Bankruptcy Court, alleging there were no genuine issues of material fact concerning the transfer of the $33,100.00 to the Maples from Benskin. The trustee filed an objection to the motion. During the course of the proceedings, Ms. Poston died and was substituted by her daughter, Ms. Marnie Fernandez, as executrix of the estate of Beverly Poston.

The Bankruptcy Court did not issue a written ruling on the motion, and trial was held in this matter on September 2 and 3, 1993. On November 12, 1993, the Bankruptcy Court entered a memorandum Opinion. That opinion was not final, but gave the parties some instruction for trial on a related fraudulent conveyance action involving Donald Hollie, which was to commence shortly thereafter on November 15, 1993. An amended memorandum opinion ruling in the trustee's favor was entered on December 7, 1993, along with an entry of judgment.

The Bankruptcy Court found that the trustee was entitled to a judgment against the Maples in the amount of $53,100.00 plus prejudgment interest at the federal rate from the date of filing of the trustee's complaint. The Bankruptcy Court also denied the Intervenor's complaint against the Maples and the bankruptcy estate. Ms. Fernandez filed a Notice of Appeal after the notice of Entry of Judgment was entered.

**Standard of Review**

Rule 8013 states the standard of review for a bankruptcy appeal. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the Bankruptcy Court to judge the credibility of the witnesses. The Bankruptcy Court's legal conclusions and mixed questions of law and fact are subject to de novo review. In re Edward M. Johnson Associates, Inc., 845 F. 2d 1395, 1398 (6th Cir. 1988) The

standard regarding the denial of the motion for summary judgment is whether the Bankruptcy Court committed an abuse of discretion.

**Discussion**

The trustee brought a fraudulent transfer action against the Maples, pursuant to 11 U.S.C. §548, in which Ms. Poston was allowed to intervene. The Bankruptcy Court found that the proof was sufficient under both the § 548 (a) (1) requirement that the debtor had actual intent to defraud, and under the § 548 (a) (2) requirements that (A) Benskin received less than a reasonable equivalent value for such transfer, and (B) that he (i) was insolvent on the date the transfer was made, (ii) was engaged in a business with unreasonably small capital, or (iii) believed that he would incur debts that would be beyond his ability to pay. 11 U.S.C. § 548. This court must affirm the Bankruptcy Court's conclusions unless it determines that such findings are clearly erroneous. In re Allegheny International Inc., 954 F.2d 167 (3rd Cir. 1992); Bankr. Rule 8013.

§ 548(a) (1) Requirement

The Bankruptcy Court found under the § 548(a) (1) requirement that the transfers were made with the debtor's "actual intent to hinder, delay, or defraud" other creditors was satisfied by the guilty pleas to the related criminal charges made by the debtor. The indictment to which Mr. Benskin pleaded guilty evinces a scheme to defraud and control' investor's funds. Furthermore, Mr. Benskin's and his company's use of an "escrow" account where all the investor's funds were co-mingled also establishes an intent to defraud. Mr. Benskin's personal and operating expenses were paid out of this "escrow" account. The debtor controlled the account; no separate funds were segregated, except in restricted accounts, such as IRA'S. The debtor

routinely issued false statements to customers. The debtor's intent to defraud investors by use of a Ponzi scheme "is not debatable." Conroy v. Shott, 363 F. 2d 90 (6th Cir. 1966). Clearly, the § 548(a) (1) element of the opinion of the Bankruptcy Court is affirmed.

§ 548(a) (2) Requirements

The Court must now consider whether (A) Benskin received less than reasonable equivalent value for such transfer from his account to the Maples, and (3) that he (i) was insolvent on the date the transfer was made, (ii) was engaged in a business with unreasonably small capital, or (iii) believed that he would incur debts that would be beyond his ability to pay in order to affirm the opinion of the Bankruptcy Court.

The proof at the trial of the case at hand established that between September 1984, and November 7, 1987, the Maples had invested only $7,500.00 with the debtor. Prior to one year before the involuntary filing, the Maples had their original investment returned to them. Thus, they gave no value for their withdrawn of $53,100.00. This Court finds that the transfers to the Maples totaling $53,100.00 represent false "profits" for which the debtor received no value. No new "investment" was made by the Maples beyond their initial $7,500.00. Therefore, the § 548 (a) (2) (A) requirement is satisfied.

The analysis under the second part § 548 (a) (2) can be satisfied in one of several ways: the trustee may show that the debtor was insolvent at the time of the transfer or because the transfer was made, pursuant to 11 U.S.C. § (A) (2) (b) (i), or, the trustee may show that the debtor was engaged in business with unreasonably small capital. 11 U.S.C. § (A) (2) (b) (ii). As a third alternative, the trustee may prove that the debtor intended to or believe that he would incur debts beyond his ability to pay. 11 U.S.C. § 548 (a) (2) (B) (iii).

The Court concludes that the trustee has established each of these elements. The debtor has admitted that both he and his company were insolvent throughout 1988. As debtor was operating a business on fraudulently obtained funds, the element that the debtor was engaged in a business with little, if any, operating capital is satisfied. Finally, when the payment of $53,100.00 was made to the Maples, the evidence showed that the debtor was unable to pay other obligations he had incurred. Therefore, after a de novo review, the Court concludes the Bankruptcy Court's findings are affirmed that the trustee has established all of the §548(a) elements to avoid the transfer to the Maples.

The Court will address Ms. Poston's argument that since the funds disposed of by the debtor were "stolen," the debtor had no interest in them, and therefore, they are not part of the estate. The Court concludes that argument to be without merit. All § 548 requires is that the debtor have an "interest" in the funds. The debtor is not required to have a legal or equitable interest in the property.

> There is no argument but that the investors gave their money to the Debtor voluntarily. Thus, at the time of each investment, the Debtor had at least the legal right to possession. it is elemental property law that one of the "interests in property" included in the total bundle of property rights is the right of possession. All § 548 requires is that the transfer of an "interest" by the Debtor.

In re M & L Business Machine Co., Inc., 160 Bankr. R. 851 (Bkrtcy. D. Colo. 1993).

Ms. Poston's contention that the Bankruptcy Court erroneously concluded that the trustee of the bankruptcy estate has a superior right to that of the true owner to recover funds

"stolen" from the true owner by the debtor and transferred by the debtor to a third party is without merit.

Denial of Summary judgment

The Court must now consider whether the Bankruptcy's Court refusal to grant Ms. Poston's motion for summary judgment was an abuse of discretion. Pinnery Dock & Transportation Co. v. Penn Central Corp., 838 F.2d 1445, 1472 (6th Cir. 1988), cert. denied, 488 U.S. 880 (1988) The intervenor, Ms. Fernandez, as executrix, argues that the Bankruptcy Court never set Poston's action for summary judgment for a hearing as required by the Local Rule 6 (l) (6). The Bankruptcy Court, after the conclusion of the proof denied Poston's motion for summary judgment in an oral ruling. Ms. Fernandez quotes Judge Brown as saying:

> I respectfully deny your motion. I will consider all the evidence that I have heard. As I have commented before, this whole issue of tracing is extremely difficult, extremely troubling to me to balance out all the conflicting policy, factual and legal issues, and it would be a disservice to the parties for me to grant summary judgment. It would only result in two appeals. I'm going to decide the case. So I will deny summary judgment. I will take under advisement, of course, the entire adversary proceeding.

The Court concludes that the denial of the order granting Poston's motion for summary judgment was not an abuse of discretion. This Court can reverse the trial court's decision only if it abused its discretion by committing a clear error of judgment. Monette v. Am-7-7 Baking Co., 929 F. 2d 276 (6th Cir. 1991) Although different and novel interpretations of the events chat occurred are possible in this instance, this Court believes the final order issued by the Bankruptcy Court is the

correct conclusion of law and findings of facts. Therefore, considering the analysis from the previous section, the intervenor's contention that the denial of the motion for summary judgment was an abuse of discretion is without merit.

The opinion of the Bankruptcy Court in this matter is affirmed.

It is so ordered this 22 day of February, 1994.

**UNITED STATES DISTRICT COURT**
**WESTERN DISTRICT OF TENNESSEE**
**WESTERN DIVISION**

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**IN RE:** ]
]
**MARK BENSKIN & COMPANY**
] **FILED: FEBRUARY 22, 1994**
**GEORGE EMERSON, TRUSTEE**
]
**Plaintiff/Appellee,** ]
]
**v.** ] **Civil Action No. 94-2056 H**
]
**DONALD AND KATHERINE HOLLIE,**
]
**Defendants/Cross-Defendants**
]
**and** ]
]
**DONALD RUTHERFORD,** ]
]
**Defendant/Intervenor/**
**Cross-Plaintiff/Appellant.**

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**ORDER AFFIRMING MEMORANDUM OPINION OF BANKRUPTCY COURT**

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This matter is an appeal of right by Donald Rutherford from a judgment of the United States Bankruptcy Court for the Western District of Tennessee in an adversary case. Mr. Rutherford is the defendant/intervenor/cross-plaintiff and appellant in this matter. The other defendants, the Hollies, have

settled this matter with George Emerson, the trustee and plaintiff-appellee, and have been dismissed from this action. This Court has jurisdiction pursuant to 28 U.S.C. § 158.

The issues presented for review by the appellant are as follows:

1. Whether the Bankruptcy Court erroneously concluded that the trustee of the bankruptcy estate has a superior right to that of the true owner to recover funds stolen from the true owner by the debtor and transferred by the debtor to a third party?

2. Whether the Bankruptcy's Court refusal to grant Mr. Rutherford's motion for summary judgment was an abuse of discretion?

## Statement of the Case

George Emerson ("trustee") brought this adversary proceeding against defendants Donald and Katherine Hollie seeking recovery of $65,569.53 transferred to them by a check issued by Mark Benskin & Co., Inc. (hereinafter "Benskin"). The trustee sought to avoid the transfer under 11 U.S.C. § 547 [preference] and § 548 [fraudulent transfer].

Donald Rutherford was permitted to intervene as a defendant, and he filed an answer to the complaint and a cross-complaint against the Hollies alleging the debtor had "stolen" $50,000.00 of his funds and had distributed those "stolen" funds to the Hollies. Mr. Rutherford alleged the trustee was not entitled to recover those funds as part of the bankruptcy estate. Defendants Donald and Katherine Hollie filed an answer to the complaint and crosscomplaint denying the allegations made by the trustee and Mr. Rutherford.

On 11 June 1990, Mr. Rutherford filed a motion for summary judgment in the Bankruptcy Court alleging there were no genuine issues of material fact concerning the transfer of the

$50,000.00 to the Hollies from Benskin. The trustee and the Hollies filed a response in opposition to the motion, with the trustee claiming he was entitled to judgment as a matter of law. On 25 January 1991, the Bankruptcy Court denied Mr. Rutherford's motion for summary judgment because that Court deemed there was a factual dispute as to the creation of a trust.

On 11 December 1991, the Bankruptcy Court issued a preliminary injunction enjoining the Hollies from dissipating, spending or transferring the funds they received from Benskin. After additional discovery, Mr. Rutherford filed a second motion for summary judgment, alleging he was entitled to the funds recovered from the Hollies. Again, the Hollies objected to the motion, and the trustee filed his own motion for summary judgment on the preference claim against the Hollies.

The Bankruptcy Court denied the trustee's motion on the preference claim. That Court then issued a memorandum opinion and proposed findings of fact and a proposed order granting Rutherford's motion for summary judgment. The Bankruptcy Court found, "[t]his Court, sitting as a court of equity, is convinced that to deny Mr. Rutherford recovery of the funds he has traced no the Hollies would result in a "blatant and manifest injustice and would permit unjust enrichment." Various motions were then filed by the parties to reconsider or modify the proposed findings of fact. The trustee filed another motion against the Hollies, this one based upon fraudulent transfer. The Hollies filed a motion requesting the Bankruptcy Court conduct a settlement conference.

Eventually, the Hollies settled with the trustee for $60,000.00, which was placed in an escrow account with counsel for the trustee and Mr. Rutherford as joint trustees. The Bankruptcy Court subsequently withdrew its previously filed Memorandum Opinion. Counsel for the trustee and Mr.

Rutherford were ordered to attend a status conference by the Bankruptcy Court. At that status conference, the Bankruptcy Court set the case for trial on 15 November 1993.

The case was tried on 15 November 1993. At the conclusion of the trustee's evidence, the Bankruptcy Court granted Mr. Rutherford a directed verdict as to the trustee's preference complaint. On 8 December 1993, the Bankruptcy Court entered a Memorandum Opinion and Judgement holding that the trustee had proven under 11 U.S.C. § 548 (a) a fraudulent transfer. The Court entered a judgment in favor of the trustee and awarded the trustee the entire $60,000.00 escrow fund created by the Hollies' settlement. Rutherford's complaint against the Hollies escrow fund was denied as well as Rutherford's claim against the bankruptcy estate except as a unsecured claim. The court incorporated by reference its memorandum opinion in a related case. [Emerson v. Maples, et al. (In re Mark Benskin & Co., Inc.), Adv. Proc. No. 91-0157 (Bankr. W.D. Tenn. Dec. 7, 1993)].

**Standard of Review**

Rule 8013 states the standard of review for a bankruptcy appeal. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the Bankruptcy Court to judge the credibility of the witnesses. The Bankruptcy Court's legal conclusions and mixed questions of law and fact are subject to de novo review. In re Edward M. Johnson & Associates, Inc., 845 F 2d. 1395, 1398 (6th Cir. 1988). The standard regarding the denial of the motion for summary judgment is whether the Bankruptcy Court committed an abuse of discretion.

**Discussion**

The trustee brought a fraudulent transfer action against the Hollies pursuant to 11 U.S.C. §548, in which Mr. Rutherford

was allowed to intervene. The Bankruptcy Court found that the proof was sufficient under both the § 548 (a) (1) requirement that the debtor had actual intent no defraud, and under the § 548 (a) (2) requirements that (A) Benskin received less than a reasonable equivalent -value for such transfer, and (B) that he (i) was insolvent on the date the transfer was made, (ii) was engaged in a business with unreasonably small capital, or (iii) believed that he would incur debts that would he beyond his ability to pay. 11 U.S.C. § 548. This court must affirm the Bankruptcy Court's conclusions unless it determines that such findings are clearly erroneous. In re Allegheny International Inc., 954 F.2d 167 (3rd Cir. 1992); Bankr. Rule 8013.

§ 548 (a) (1) Requirement

The Bankruptcy Court found under the § 548 (a) (1) requirement that the transfers were made with the debtor's "actual intent to hinder, delay, or defraud" other creditors was satisfied by the guilty pleas to the related criminal charges made by the debtor. The indictment to which Mr. Benskin pleaded guilty evinces a scheme to defraud and control investor's funds. Furthermore, Mr. Benskin's and his company's use of an "escrow" account where all the investor's funds were co-mingled also establishes an intent to defraud. Mr. Benskin's personal and operating expenses were paid out of this "escrow" account. The debtor controlled the account; no separate funds were segregated, except in restricted accounts, such as IRA's. The debtor routinely issued false statements to customers. The debtor's intent to defraud investors by use of a Ponzi scheme "is not debatable." Conroy v. Shott, 363 F. 2d 90 (6th Cir. 1966). Clearly, the §548 (a) (1) element of the opinion of the Bankruptcy Court is affirmed.

§ 548 (a) (2) Requirement

The Court must now consider whether (A) Benskin received less than reasonable equivalent value for such transfer from his account to the Hollies, and (3) that he (i) was insolvent on the date the transfer was made, (ii) was engaged in a business with unreasonably small capital, or (iii) believed that he would incur debts that would be beyond his ability to pay in order to affirm the opinion of the Bankruptcy Court.

The proof at the trial of the case at hand established the Hollies had invested only $4,800.00 with the debtor, and they had previously withdrawn $22,000.00. Thus, they gave no value or their withdrawn of $65,569.93. This Court finds that the transfers to the Hollies totalling $65,569.93 represent false "profits" for which the debtor received no value. No new "investment" was made by the Hollies beyond their initial $4,800.00. Therefore, the §548 (a) (2) (A) requirement is satisfied.

The analysis under the second part § 548 (a) (2) can be satisfied in one of several ways: the trustee may show that the debtor was insolvent at the time of the transfer or because the transfer was made, pursuant to 11 U.S.C. § (A) (2) (b) (i), or, the trustee may- show that the debtor was engaged in business with unreasonably small capital. 11 U.S.C. § (A) (2) (b) (ii). As a third alternative, the trustee may prove that the debtor intended to or believe chat he would incur debts beyond his ability to pay. 11 U.S.C. § 548 (a) (2) (B) (iii).

The Court concludes that the trustee has established each of these elements. The debtor has admitted that both he and his company were insolvent throughout 1988. As debtor was operating a business on fraudulently obtained funds, the element that the debtor was engaged in a business with little, if any, operating capital is satisfied. Finally, when the payment in

excess of $65,000.00 was made to the Hollies, the evidence showed that the debtor was unable to pay other obligations he had incurred. Therefore, after a de novo review, the Court concludes the Bankruptcy Court's findings that the trustee has established all of the § 548 (a) elements to avoid the transfer to the Hollies is affirmed.

The Court will address Mr. Rutherford's argument that since the funds disposed of by the debtor were "stolen," the debtor had no interest in them, and therefore, they are not part of the estate. The Court concludes that argument to be without merit. All § 548 requires is that the debtor have an "interest" in the funds. The debtor is not required to have a legal or equitable interest in the property.

> There is no argument but that the investors gave their money to the Debtor voluntarily. Thus, at the time of each investment, the debtor had at least the legal right to possession. It is elemental property law that one of the "interests in property" included in the total bundle of property rights is the right of possession. All § 548 requires is that the transfer of an "interest" by the Debtor.

In re M & L Business Machine Co., Inc., 160 Bankr. R. 851 (Bkrtcy D. Colo. 1993).

Mr. Rutherford's contention that the Bankruptcy Court erroneously concluded that the trustee of the bankruptcy estate has superior right to that of the true owner to recover funds "stolen" from the true owner by the debtor and transferred by the debtor to a third party is without merit.

Denial of Summary Judgment

The Court must now consider whether the Bankruptcy's Court refusal to grant Mr. Rutherford's motion for summary judgment was an abuse of discretion. Pinnery Dock &

Transportation Co. v. Penn Central Corp., 838 F.2d 1445, 1472 (6th Cir. 1988), cert. denied, 488 U.S. 880 (1988). The intervenor, Mr. Rutherford, argues that because the Bankruptcy Court made findings of fact and conclusions of law that were in opposition to those entered in an earlier order, the Bankruptcy Court committed an abuse of discretion. The trustee argues that as the order that was withdrawn did not dispose of all claims, it was subject to revision. The trustee cites Rule 54 (b) of the Federal Rules of Civil Procedure in support of his position.

The Court concludes that the withdraw of the order granting Rutherford's motion for summary judgment was not an abuse of discretion. Although different and novel interpretations of the events that occurred are possible in this instance, this Court believes the final order issued by the Bankruptcy Court is the correct conclusion of law and findings of facts. Therefore, considering the analysis from the previous section, the intervenor's contention that the reversal of the order granting the second motion for summary judgment is without merit.

The opinion of the Bankruptcy Court in this matter is affirmed.

It is so ordered this 22 day of February, 1994.

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

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IN RE:

MARK BENSKIN & CO., INC.,
Chapter 7
Debtor.
(Involuntary)

FILED:
DECEMBER 7, 1993

BK #89-22793-B

GEORGE EMERSON, Trustee,

Plaintiff,

v.

Adversary
Proceeding
No. 91-0157

RAY MAPLES and BRENDA MAPLES,

Defendant/Cross Defendants,

AND

BEVERLY POSTON,

Defendant/Intervenor/
Cross Plaintiff.

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## AMENDED MEMORANDUM OPINION

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In this adversary proceeding, the Trustee filed a complaint, now amended, against Ray and Brenda Maples,

seeking to avoid certain transfers from the debtor to the Maples as fraudulent conveyances under 11 U.S.C. §548. The issues raised in that complaint are core under 28 U.S.C. §157(b)(2)(H). Beverly Poston[1] was allowed to intervene in this adversary proceeding, and she filed a cross claim against the Maples, in which Beverly Poston asserted trust, fraud and conversion theories in an effort to obtain a judgment against the Maples for $33,100.00 plus accrued interest from December 8, 1988, and punitive damages. The Poston claims involve determinations of transfer avoidance, property of the estate and allowance of claims against the estate and are core pursuant to 28 U.S.C. §157(b)(2)(A), (B) and (H). The parties consented to a trial without a jury, and the Court will enter a final order on all issues, subject to appeal pursuant to 28 U.S.C. §158.[2] This opinion contains findings of fact and conclusions of law pursuant to F.R.B.P. 7052. The Court issued its original opinion on November 12, 1993, as an accommodation to counsel who had a trial in November in another similar adversary proceeding, and the Court reserved the opportunity to make revisions in that opinion. A final order and judgment will be entered at this time.

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1 Beverly Poston is now deceased and her daughter and executrix Marnie Fernandez has been substituted.

2 It could be concluded that the dispute between the Poston estate and the Maples is a noncore but otherwise related proceeding, as the Poston estate seeks a monetary recovery from the Maples, who are not debtors under Title 11. However, the gravamen of the dispute is whether the Maples owe the Poston estate or the bankruptcy estate and that determination requires decisions in core issues. Moreover, the Court understands that the parties consented to a final judgment from this court, subject to the parties' appeal rights.

## HISTORY OF THE CASE

As a background to this adversary proceeding, two involuntary bankruptcy petitions were filed against the debtor and against a related debtor, Mark Stephen Benskin, on April 14, 1989. Orders for relief were subsequently entered pursuant to 11 U.S.C. §303(h), and the Trustee filed numerous avoidance proceedings. It has been established clearly in the proof that Mr. Benskin conducted his business as a sole proprietorship ignoring corporate formalities. Generic references to the debtor in this opinion may refer to either debtor. Both debtors were substantially engaged in an illegal Ponzi scheme, through which the debtors obtained funds from some clients, such as Beverly Poston, under the false pretense of making investments for them. he debtor engaged in some legitimate business activity, for example, when it handled restricted accounts such as IRAs. However, illusory profits were often paid to some clients, such as the Maples, out of the funds paid in by new clients, such as Beverly Poston, and that is frequently the case in such schemes. See, e.g., Rosenberg v. Collins, 624 F. 2d 659, 663-64 (5th Cir. 1980); Emerson v. Marty, et al. (In re Mark Benskin & Co., Inc.), 135 B.R. 825 (Bankr. W.D. Tenn. 1991); compare, Duvoisin v. Evans (In re Southern Industrial Banking Corp.), 159 B.R. 224 (Bankr. E.D. Tenn. 1993) (where Judge Kelley distinguished legitimate business activity from an overall Ponzi scheme). Mr. Benskin and the debtor corporation pled guilty to a multi-count federal indictment. U.S. v. Benskin, 926 F. 2d 562 (6th Cir. 1991). In an earlier opinion in this case, the Court denied the Trustee's action seeking a preferential transfer avoidance and recovery against different pates due to a failure of proof and allowed a tracing by another intervenor so as to give that intervenor a recovery against that defendant. Emerson v. Marty, 135 B.R. at 832. However, the Court

> observe[d] that this result may be unique to this proceeding. Had the Trustee carried the burden of proving all elements of §547(b), the Marty transfer would have been an avoidable preference and, as such, it would have been property of the estate. Then, a different tracing methodology may have been employed. See, e.g., First Federal of Michigan v. Barrow, 878 F. 2d 912, 916 (6th Cir. 1989). Further, [the intervenor would have been competing as an unsecured creditor for [a] pro-rata share of the bankruptcy estate. Therefore, this opinion should not be used as a per se ruling that all intervenors necessarily would prevail against the bankruptcy Trustee.

Id. at 834.

The instant adversary proceeding presents the Court with a distinct confrontation between the federal bankruptcy doctrine of equality of distribution for the benefit of all unsecured creditors and state law equitable or legal principles, including specific creditor avoidance powers, that favor an innocent third party who lost money due to a debtor's fraud or deception. As predicted in the Court's prior Marty decision in this case, intervenors, such as the intervenor in this proceeding, may not always prevail in this type of confrontation. The Court has analyzed the totality of the particular facts in this adversary proceeding and the result, while not one that rests comfortably with the Court's sense of equity toward Beverly Poston, is dictated by the particular facts. This is a proceeding where the equities may be argued strongly for both the Trustee and Beverly Poston and a result may be justified for either. After a balancing of all factors, the Court must decide in favor of the Trustee.

## DISCUSSION

The Trustee's complaint pleads a cause of action under 11 U.S.C. §548 that provides:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily -
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction or was about to engage in business or a transaction for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

Specifically, the Trustee seeks to avoid and recover transfers made to the Maples within one year before the bankruptcy filing, and those transfers total $53,100.00.[3] See Trustee's Amended Complaint. The Trustee's complaint relied upon the transfers being made with the debtor's "actual intent to hinder, delay, or defraud" other creditors. 11 U. S.C. §548(a)(1). The proof demonstrated that the debtor, and its principal Mark Benskin, knew when paying the Maples that there were insufficient assets to satisfy other creditors. The debtors' intent to defraud creditors was established by the guilty pleas to the related criminal charges and preclusive effect may be given to those guilty pleas as factual findings to the extent that the debtors' intent to defraud creditors is required in this adversary proceeding. The indictment to which Mr. Benskin and his

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[3] The transfers subject to avoidance are:

| checks dated: | | |
|---|---|---|
| 4/18/88 | $10,000.00 | to Ray Maples (Ex. 7) |
| 12/2/88 | 25,000.00 | to Ray Maples (Ex. 9) |
| 12/2/88 | 5,600.00 | to Ray or Brenda Maples (Ex. 10) |
| 12/5/88 | 1,000.00 | to Sandra Maples and endorsed for deposit by Ray Maples (Ex. 11) |
| 12/7/88 | 1,500.00 | to Kaye Maples and endorsed for deposit by Ray Maples (Ex. 8) |
| 1/2/89 | 10,000.00 | to Brenda Maples (Exs. 6, 24) |
| | $53,100.00 | |

of Mr. Benskin, and it clearly alleges a scheme by both Mr. Benskin and his solely controlled company to defraud creditors, including a scheme to control the investors' funds and to use those funds for the debtors' benefit. By pleading guilty the debtors admitted, among other things, misappropriation of customers', including Beverly Poston's, funds and misrepresentation to customers of the status of or return on their investments. Moreover, the Trustee admitted that the debtor obtained Beverly Poston's funds by fraud. See Stipulated Facts.

In reality, Mr. Benskin and his company maintained no separate client accounts or trust accounts. The evidence clearly established that the debtor used its "escrow" bank account at National Bank of Commerce in Memphis as a general account. Client funds were commingled and deposited there, and clients were paid from that account. However, Mr. Benskin's personal and operating expenses were also paid routinely from that account. In no manner did the debtor treat the "escrow" account as a trust account nor did the debtor segregate client funds. As will be seen, the facts that the debtor controlled the account, that no funds were segregated, and that no separate identity of client funds was maintained will be crucial to the analysis of Beverly Poston's claims.

When the debtor did invest in a nonrestricted account, trades of those accounts resulted in checks payable to the debtor rather than to the debtor's customers. Only when the debtor invested in restricted accounts did the debtor place its customer's name on the account. The debtor did occasionally use restricted accounts, for example to rollover IRA accounts for some customers, such as Danny Livingston, a witness in this proceeding.

The debtor routinely issued false account statements to its customers. The use of such false statements led the customers to believe that investments had been made and that returns were

being realized when such information had been fabricated as a part of the debtor's illegal scheme. See, e.g., Exhibit 1, stating that an investment of $137,150.34 from Beverly Poston had been deposited to American Capital Securities Fund "as requested by Ms. Beverly Poston." No such deposit had been made on her behalf or in her name. As to American Capital, the debtor was not an agent for American Capital, which was the parent to several mutual fund managed accounts. The debtor would invest in American Capital through another company in Jackson, Mississippi. The debtor's investments in American Capital were never in the customer's name, and the American Capital investments also were not segregated into customer accounts.

Mr. Benskin testified that he met with Beverly Poston and her daughter Marnie Fernandez in the Poston home and that it was his suggestion that she invest in American Capital. He denied that Beverly Poston or Marnie Fernandez instructed him to only invest in American Capital or in government funds. Mr. Benskin further stated that there was no written trust agreement with Mrs. Poston and that he was given total discretion by Mrs. Poston to invest her funds. Quite obviously, Mrs. Poston did not agree to allow Mr. Benskin to convert her funds but it is evident that he did so. He testified that his company's account statements to Mrs. Poston were false, including the one dated November 17, 1988, showing an account balance of $137,150.34 invested in American Capital. Ex. 1. This admittedly false statement somewhat belies Mr. Benskin's denial that he was instructed to invest in American Capital for Mrs. Poston.

Mrs. Poston gave two casher's checks to the debtor totalling $137,150.34, and they were deposited in the escrow account, commingled with three other deposits, on November 17, 1988. Exs. 2 & 4. As stated, those funds were not invested exclusively for Mrs. Poston; rather, the debtor used these as the

debtor used other customer funds, for personal and operating expenses, for general investments in the market and for payment to other customers such as the Maples. Mrs. Poston did not have a restricted account such as an IRA, that would have assured investments in her name.[4]

## AVOIDANCE AND LIABILITY OF TRANSFEREES

Looking first to the Trustee's fraudulent conveyance claims against the Maples, the Trustee has met his burden of proof by a preponderance of be evidence[5] that the Maples were transferred funds within the one year of the bankruptcy filings and that these transfers were made voluntarily by the debtor with actual intent to hinder, delay or defraud other creditors to whom the debtor was then obligated. As stated, the debtor's guilty plea established that. Moreover, the totality of the proof established the existence of an illegal scheme that had at its heart a fraudulent motive. Included in the proof was testimony from Allen Exelbierd, the Trustee's public accountant, who demonstrated that his review of the debtor's deposit slips and checks for 1986 through 1988 revealed an excessively large "fee" taken by the debtor from customers' "investment" funds, an inconsistency between the checking account transactions of the debtor and the false statements issued to customers, a failure of the debtor to invest all of its customers' funds, and a use of the debtor's escrow account for non-customer purposes. The Court does not believe any of the parties deny the debtor's fraudulent intent and there can be no doubt of it. As one court observed "The statutory language makes it plain that one can infer an

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[4] In contrast, Danny Livingston testified that he instructed Mark Benakin to place his funds in an IRA and the debtor did so.

[5] The evidence is actually clearly and convincingly in favor of the Trustee's §548 avoidance and recovery.

intent to defraud from the mere fact that Debtors were operating a Ponzi scheme." Raforth v. The First National Bank of Barnesville, et al. (In re Baker & Getty Financial Services, Inc.), 98 B.R. 300, 308 (Bankr. N.D. Ohio 1989).

Therefore, under §548(a)(1) the transfers from the debtor to the Maples are avoidable. However, to illustrate the overwhelming justification for avoidance, the Court also has analyzed constructive fraud under §548(a)(2). For purposes of this subsection it is first necessary to show that the debtor/ transferor received "less than a reasonably equivalent value in exchange for" the transfers. 11 U.S.C. §548(a)(2)(A).

The Maples had invested, between September 1964, and November 7, 1987, a total of $7,500.00 with Mark Benakin. Prior to §548's one year reach-back period, the Maples had been paid a "return" in excess of their "investments." Exhibit 25, Interrogatory Answers of Brenda Maples. During the one year reach-back period the Maples, in their names or in the names of their dependent children, received $53,100 from the debtor. The two checks to the children were endorsed by and controlled for deposit by Ray Maples. Supra note 3. There were no new deposits by the Maples to justify such a return. Quite simply, the debtor fabricated a "profit" in the Maples' account and paid it to them upon their requests for withdrawals. The debtor received no value in exchange for the transfers to the Maples within that one year time period. Obviously, no value is not reasonably equivalent value.

The second step under §548(a)(2) presents alternatives. A trustee may show that the debtor was insolvent at the time of the transfer or became insolvent as a result. 11 U.S.C. §548(a)(2)(B)(i). Or, a trustee may prove that the debtor engaged in business with unreasonably small capital. 11 U.S.C. §548(a)(2)(B)(ii). Or, a trustee may prove that the debtor intended to or

believed that it would incur debts beyond the debtor's ability to repay. 11 U.S.C. §548(a)(2)(B)(iii). Here, this trustee has established each of these elements. Mark Benskin admitted that he and his company were insolvent throughout 1988. Mr. Exelbierd's review indicated insolvency from January 1, 1988, through April 18, 1989. The testimony of Mr. Benskin, of Mr. Exelbierd, and documentary proof also established that when the payments were made to the Maples the debtor was unable to pay other obligations that it incurred. Moreover, the fact that the debtor operated primarily if not exclusively on fraudulently obtained funds establishes that the debtor had little if any legitimate operating capital. It would seem axiomatic that the debtor was operating its business with unreasonably small capital.

In summary, the Trustee has established all necessary §548(a) elements to avoid the transfers to the Maples. The Maples only "defense" is actually their attempted justification that their withdrawals were represented to them to be their "profits" on investments. As the profits were falsified by the debtor there is no such justification for the Maples' withdrawals. Counsel for the Maples also argued that the check dated April 18, 1980 (supra note 3) should not be avoidable as it fell outside the one year prior to the entry of the order for relief on June 12, 1989.

However, §548(a) allows avoidance of transfers made within one year of the "date of the filing of the petition." 11 U.S.C. §548(a). Section 101(42) of the Code defines "petition" to mean "petition filed under section 301, 302, 303 or 304 of this title, commencing a case under this title.' In an involuntary case such as this one, the statutory language mandates that the trigger date for avoidance reach back is the filing date rather than the date of the order for relief.

While there was some proof that the Maples at some point knew that Mr. Benskin was under investigation by law

enforcement authorities, there is no proof that the Maples knew of the debtor's specific fraudulent acts. The intervenor established that the Maples were paid a profit far in excess of their investment[6] and that they paid taxes in 1988 on a zero basis return of $46,668.00 from the debtor. Ex. 19. There was proof upon which a factual basis exists for the Court to be dubious of the Maples' avowed lack of suspicion as to the debtor's business activities, but the Court's concern does not aid Beverly Poston in that there is insufficient proof to find that the Maples knew that the source of their withdrawals was other customers' money. Section 548 does not, moreover, test the knowledge or intent of the transferee. It is the debtor/transferor's fraudulent intent or constructive fraud that is at issue and has been proven here.

Having determined that the transfers were fraudulent and avoidable, §550 addresses the liability of the transferee. The Trustee is entitled to recover the value of the transfers and this Court finds that the value can be returned to the bankruptcy estate only if the Trustee obtains a judgment for the avoided transfers, plus prejudgment interest at the federal rate[7] from the date of the filing of this complaint. The judgment will be joint and several against Ray and Brenda Maples and it shall include the amount of the two checks totalling $2,500.00 made payable to Sandra and Kaye Maples, but endorsed and deposited by Ray Maples. Therefore, the judgment against Ray and Brenda Maples as initial transferees under 11 U.S.C. §550(a)(1) is for

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[6] The Maples withdrew a total of approximately $85,000.00 and invested at most $24,000.00 over their investment history with the debtor from 1984 to 1989.

[7] See 28 U.S.C. §1961; Dvoisin v. Anderson, et al. (In re Southern Industrial Banking Corp., 87 B.R. 518, 523 (Bankr. E.D. Tenn. 1988).

$53,100.00, plus prejudgment interest at the federal rate from the date of filing of the Trustee's complaint.

LIABILITY TO INTERVENOR

As to the intervenor's claims against the Maples, the Poston estate asserts that it should prevail against the first $33,100.00, plus accrued interest and punitive damages, recovered from the Maples. Thus, the intervenor's recovery would be given superiority over the Trustee's avoidance recovery if the intervenor's theory is accepted. The Poston estate alleges that a fiduciary obligation was created when Beverly Poston surrendered her funds to Mark Benskin with instructions to deliver the funds to American Capital.

An express trust is asserted and the Poston estate relies in part on its belief that Mark Benskin held himself out to be an agent for American Capital. The Court does not find that "[t]his was an express trust in every way.' In re Elrod, 42 B.R. 468, 473 (Bankr. E.D. Tenn. 1984) citing Bogert, LAW OF TRUSTS 23 (5th Ed. 1973) for elements of an express trust). The Court understands that an express trust does not require a writing. Kopsombut-Myint Buddhist Center v. State Board of Equalization, 728 S.W.2d 327 (Tenn. App. 1986). The testimony of Beverly Poston establishes that she relied upon Mark Benskin to invest her funds but she was not relying upon his alleged agency with American Capital. Rather, she learned of Mr. Benskin through family and friends "who had used Mr. Benskin as an advisor, consultant, whatever. And so we decided that it might be wise to talk with him and consider turning that over to him." Ex. 30, p. 22. The Court finds that Beverly Poston wanted her funds placed in treasury bills (Ex. 30, p. 24) but that does not require a finding that Mark Benskin was an agent of American Capital. In fact, he was not and had no representative capacity to act for American Capital. Mark Benskin was, however, acting in

a fiduciary capacity as to Beverly Poston when he persuaded her to place her funds with him for investment. But the proof does not persuade the Court that an express trust was created.

Thus, the next inquiry is whether a constructive trust existed between Beverly Poston and the debtor and whether it was perpetuated until the bankruptcy filing. In addition to the general trust requirements of a trustee, a beneficiary, and identifiable trust property, a constructive trust requires proof of: "(1) a wrongful act; (2) specific property acquired by the wrongdoer which is traceable to the wrongful behavior; and (3) an equitable reason why the party holding the property should not be allowed to keep it." Merrill v. Abbot, et al. (In re Independent Clearing House Co., et al.), 41 B.R. 985, 1000 (Bankr. D. Utah 1984) (citations omitted), aff'd. in part, rev'd. in part, 62 B.R. 118 (D. Utah 1986). See also Emerson v. Marty, 135 B.R. at 833 (citing Kopsombut-Myint Buddhist Center v. State Board of Equalization, 728 S.W. 2d at 333). This latter requirement is ordinarily met when it can be shown that the party holding such property is not a good faith, bona fide purchaser for value. See, e.g. CH Robinson Co. v. Trust Co. Bank, N.A., 952 F.2d 131 (11th Cir. 1992), reh'g denied 961 F. 2d 224 (1992); Garland v. Higgins, 160 Tenn. 381, 25 S.W.2d 583 (Tenn. 1930). Where such a party qualifies as a good faith purchaser for value, the rights of an express or constructive trust beneficiary are defeated. Garland v. Higgins, 25 S.W. 2d at 585.

The Court easily can find that the debtor was not a good faith, bona fide purchaser of Mrs. Poston's funds, as it has been established that it obtained them by fraud. However, the major impediment to a conclusion that either an express or constructive trust existed as to the Poston funds is that the funds were not segregated and that they were not perpetuated as a trust property by the debtor until the bankruptcy filing.

The intervenor's case rests in large part upon the success of tracing Beverly Poston's deposit on November 17, 1988, to the payment to the Maples. The intervenor established that in the fall of 1988, the National Bank of Commerce internally used methodology of first posting credits, such as deposits, then posting debits, such as bank charges and then posting debits for checks, with the smallest check on a given clearing day posted first. However, this internal bank policy of first in, first out posting does not establish what occurs when a bankruptcy petition is filed after the account reaches a zero balance or a balance lower than the deposit in question. See, e.g., First Federal of Michigan v. Barrow, 878 F. 2d 912, 916 (6th Cir. 1989) (for discussion of "lowest intermediate balance test"). The posting procedure was for internal bank purposes only, and Mr. James L. Lindsey, Vice President of the Bank, testified that the Bank did not monitor an "escrow" account to assure that it was used properly. Mr. Lindsey also agreed that intermingled funds generally lost their identity.

Mr. Exelbierd testified that in 1988, the aggregate amount of $1,991,902.39 was deposed into the escrow account and $1,914,775.73 was disbursed from that account. At the end of 1988 the debtor had total cash and assets of $425,588.67 but investor liability on a cash basis of $732,000.00. The debtor's fabricated statements to customers showed a liability to customers of $5.2 million. The Court does have proof in this proceeding, through the cross examination testimony of the intervenor's expert certified public accountant, Jerry Whitehorn, that the escrow account reached zero subsequent to the Poston deposit

and prior to the bankruptcy filing.[8] Moreover, it is clear from an analysis of the bank account that Beverly Poston's deposit was subsequently reduced and depleted. See Exs. 4, 5, 15, 28 & 29. That is, the debtor used the bank credit resulting from the Poston deposit to pay numerous checks written on the account, and the bank debited the account for those checks. The Poston estate offered clear and extremely well prepared proof to show the internal tracing of the debits from the Poston deposit. See, e.g., Exs. 28 & 29. By following the bank's internal posting methodology four checks to the Maples totalling $33,100.00 can be traced back to the Poston deposit. Exs. 28 & 29.

However, this Court is not persuaded that the bank's internal posting methodology and its resulting tracing is dispositive for purposes of this proceeding. As indicated at the beginning of this opinion, a resolution is required of the confrontation between the bankruptcy policy favoring avoidance recovery for the benefit of all unsecured creditors and Tennessee equitable or legal concepts favoring a single defrauded creditor. Absent bankruptcy creditor considerations, the Poston estate, under Tennessee law, would prevail on an equitable theory against the Maples, as the Poston estate has followed the bank's debits against her deposit into the Maples' hands. However, the proof in this proceeding has not established that any conspiracy existed between the Maples and the debtor to defraud Beverly Poston. As a result, the Poston's tracing into and recovery from the Maples would depend under state law on a creditor's action to avoid the fraudulent conveyances to the Maples. Tenn. Code

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[8] The Court has not considered as proof in this proceeding its finding number 23 in Emerson v. Marty, 135 B.R. at 829, that by "April, 1989, [o]nly a nominal amount remained in the debtor's escrow account." However, there is an admission by the Trustee in this adversary proceeding that no funds remained in the debtor's escrow account.

Annot. §29-12-101, et. seq.

Upon the filing of a bankruptcy, avoidance powers are "explicitly give[n] only to the trustee." Epstein, Nickles & White, BANKRUPTCY §6.2 at 499 (1992); 11 U.S.C. §544; 545; 547; 548; 549; 533. The Congressional policy is clear: Upon the filing of a bankruptcy the avoidance powers are intended to benefit all creditors of the bankruptcy estate. Epstein, Nickles & White, BANKRUPTCY, §6.2 at 499. To allow individual creditors, such as Beverly Poston, to pursue avoidance actions would create "a conflict with and between creditor classes." First Federal of Michigan v. Barrow, 878 F.2d at 915. This Court must consider the interests of all other creditors who are similarly situated to Beverly Poston. Counsel for Beverly Poston represented the intervenor in the Marty proceeding referred to previously and represents other intervenors, and it is clear that there were many other creditors who were defrauded by these debtors. There are insufficient bankruptcy estate assets to satisfy all creditors, and to permit recovery by the Poston estate from the Maples would reduce the recovery by the bankruptcy Trustee, with a resulting reduction in pro rata payment to other defrauded creditors. A balancing of the equities and the Congressional policy behind the Bankruptcy Code favors recovery by the bankruptcy Trustee and allowance of Beverly Poston's unsecured claim for pro rata distribution along with other defrauded holders of unsecured claims.

The Court is persuaded that the tracing demonstrated by the Poston proof is not determinative in this proceeding because Mrs. Poston's deposit into the debtor's escrow account was depleted before the bankruptcy case was filed. The debtor exercised total control over the disposition of the escrow account, resulting in the depletion of trust property, assuming that a trust was created when Mrs. Poston surrendered her funds to the

debtor.

Fundamental to this Court's ultimate conclusion is an examination of the nature and extent of the debtor's prepetition interest in the funds. Section 541(a) of the Bankruptcy Code designates any legal or equitable interests of the debtor in property at the commencement of the bankruptcy case "property of the estate" and that includes any interests recovered pursuant to applicable avoidance sections of the Code. 11 U.S.C. §541(a)(1) and (3). This is an "admittedly broad definition of includable property;" however, the nature and extent of the debtor's interests referenced by §541(a) are influenced by state law applied in a manner consistent with federal bankruptcy law. Patterson v. Shumate, ___ U.S. ___, 112 S.Ct. 2242, 2249, 119 L.Ed.2d 519 (1992); Eastlick, et al. v. North American Coin & Currency, Ltd. (In re North American Coin & Currency, Ltd.), 767 F.2d 1573 (9th Cir. 1985), am'd, 774 F.2d 1390 (9th Cir. 1985), cert.den., 475 U.S. 1083, 106 S.Ct. 1462 (1986); Sanyo Electric, Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.), 874 F.2d 88, 93 (2nd Cir. 1989); White v. White (In re White), 851 F.2d 170, 173 (6th Cir. 1988). The filing of the bankruptcy petition does not expand the debtor's property interests. The estate succeeds to property only to the extent of the right and title possessed by the prepetition debtor. United States v. Whiting Pools, 462 U.S. 198, 204, n. 8, 103 S.Ct. 2309, 2313, n. 8, 76 L.Ed.2d 515 (1983). This rule is significant here because, as mentioned above, it is generally held, pursuant to 11 U.S.C. §541(d), where a debtor holds property in trust for another that the debtor's only interest is mere legal

title.[9] Id. Moreover, in the bankruptcy context, the claim of the equitable interest holder or beneficiary to perpetuated trust assets is considered superior to that of the bankruptcy trustee's judgment lien creditor status or avoidance powers. See, e.g., Vinevard v. McKenzie (In re Quality Holstein Leasing), 752 F.2d 1009, 1012 (5th Cir. 1985); In re Howard's Appliance Corp., 874 F.2d at 93; cf. National Bank of Alaska v. Erickson (In re Seaway Express Corp.), 912 F.2d 1125, 1128 (9th Cir. 1990) (The "majority rule is that §541(d) does not limit the trustee's powers over real property under §544(a)(3)."). Indeed, the United States Supreme Court has noted that under Bankruptcy Code §541(d), the bankruptcy estate "plainly" does not include "property of others held by the debtor in trust at the time of the filing of the petition." United States v. Whiting Pools, 103 S.Ct. at 2313, n. 10; see also Begier v. I.R.S., 496 U.S. 53, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990). It must be noted that this debtor no longer held Mrs. Poston's property in perpetuated trust when the bankruptcy was filed.

Under both state law and federal bankruptcy law, the equitable interest in property acquired by fraud may remain property of its rightful owner only to the extent that it is identifiable. See, e.g., Quality Holstein Leasing, 752 F. 2d at 1012; McAllester v. Aldridge (In re Anderson), 30 B.R. 995 (M.D. Tenn. 1983); Covert v. Nashville, C & St. L. Ry., 186 Tenn. 142, 208 S.W. 2d 1008, 1 A.L.R. 2d 154 (1948). Accordingly, the fraudulent acquirer obtains mere title or a possessory interest and is said to hold identifiable property in

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[9] Section 541(d) provides in pertinent part: "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest,...becomes property of the estate...only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

trust for its beneficiary or rightful owner. Such a trust is "constructed" by a court of equity "to satisfy the demands of justice" and prevent unjust enrichment. In re Anderson, 30 B.R. at 1014. Thus, it is referred to as a "constructive trust.' Id. The §541(d) exclusion from property of the estate applies with equal force to constructive and express trusts. See, e.g., In re Howard's Appliance, 874 F. 2d at 93.

Thus, the inquiry moves more specifically to why Beverly Poston's state law recovery of her traced funds failed to survive the bankruptcy filing.

Clearly, the Maples do not qualify as good faith purchasers for value of the fraudulent conveyances to them. That finding is essential to the Trustee's §550 recovery from them. Although they may have received the transfers in good faith, they did not give value. A basic premise of avoidance law is that the transfer as avoided "is preserved for the benefit of the [bankruptcy] estate but only with respect to property of the estate." 11 U.S.C. §551. How then does avoidance and recovery from the Maples place the bankruptcy Trustee in a superior position to Mrs. Poston's estate? The first step, as previously stated, is acknowledgement that any trust fund was depleted by the debtor prior to the bankruptcy filing. As to the Poston funds, the only asset remaining in the debtor's estate at the bankruptcy filing was an avoidance action of the federal bankruptcy estate against the transferees. A trustee, under §544, has,

> [a]s of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by -

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C. §544 (§(a)(3) omitted).

These broad powers, in addition to the specific authority of §548, give the Trustee a status that is superior to Beverly Poston's position. A creditor, for example, is deprived of its authority to pursue state law avoidance actions, because §544(b) vests that authority in the bankruptcy trustee. American National Bank of Austin v. Mortgageamerica Corp. (In re Mortgageamerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983). As the Poston deposit had been depleted so that its tracing must go outside the escrow account, the Poston claims are against the same transfers that the Trustee is avoiding. Upon avoidance, the Trustee's interest

primes Beverly Poston's interest. Otherwise, as stated, the bankruptcy policy of equality of distribution for similarly located creditors and the concepts supporting §§544, 548, 550 and 551 would be defeated for the benefit of only one creditor.

It is not a simple task to justify the result of the bankruptcy estate defeating what appears to be a constructive trust. In fact, if a perpetuated trust res did exist in Beverly Poston's favor, the justification could not be made, as the trust property would never have become property of the bankruptcy estate. See 11 U.S.C. §§541 (d) and 551. The depletion of Beverly Poston's funds is the factor upon which the result rests, as her trust res disappeared and was converted into an avoidance cause of action held solely by the bankruptcy estate.

Turning more specifically to the analysis of a constructive trust in this proceeding, it is well settled that the burden of proving facts which warrant the imposition of a constructive trust and thus, application of §541(d), is on the claimant. See, e.g., First Federal of Michigan v. Barrow, 878 F. 2d at 915. If it can be demonstrated that the subject property was acquired by fraud, the claimant must then demonstrate that it can be traced. Id. at 915-916. In the bankruptcy context, sufficient tracing and identification of the trust property is essential to the establishment of a constructive trust when the funds have been commingled with other funds. According to the Sixth Circuit Court of Appeals,

> . . . the predicate for the trust doctrine as applied in bankruptcy is a perpetuated integrity of the trust properties so as to avoid conflict with and between creditor classes; ... If the trust fund or property cannot be identified in Is original or substituted form, the cestui que trust becomes merely a general creditor of the estate.

First Federal of Michigan v. Barrow, 878 F. 2d at 915 (emphasis added) (quoting in part 4 L. King, COLLIER ON BANKRUPTCY, paragraph 541.13 at 541-78 - 541-79 (15th Ed. 1988)). Therein lies the failure for the Poston estate's proof on a constructive trust: The deposit was depleted; thus, there was not a perpetuated integrity of the alleged trust deposit. The Poston estate argues that they have traced into the Maples' accounts; however, this is not tracing into assets acquired by the debtor so as to enable a trust beneficiary to recover those assets in superiority to the bankruptcy estate's recovery. See, e.g., Republic Supply Co. of California v. Richfield Oil Co., 79 F.2d 375, 377 (9th Cir. 1935). "Due to the commingling and fraud in the [Benskin escrow] account, no investor can trace his [or her] investment to any specific asset of the estate." Hatoff v. Lemons and Associates, Inc., 67 B.R. 198, 213 (Bankr. D. Nev. 1986). The Court makes this finding, notwithstanding the tracing proof produced in this proceeding, because to allow the Poston estate to trace beyond the depleted escrow funds and to compete with the Trustee would be to elevate the Poston claims above an avoidance recovery for all creditors and to allow her estate a better recovery than similarly defrauded creditors.

Another impediment to the alleged constructive trust prevailing over the Trustee's avoiding powers is that there is a factual dispute as to whether any restriction was placed on the funds by Beverly Poston. In a deposition, Beverly Poston

testified that she told Mark Benskin that she wanted her "money to go into treasury bills." Ex. 30, p;. 24. She further testified that Mr. Benskin agreed that he "would put it all in American Capital for the T-Bill." Id., p. 25. In an offer of proof, Marnie Fernandez, the daughter of Beverly Poston, confirmed her mother's instructions. Mr. Benskin denied that such a conversation occurred. The Court does not need to decide which version of the conversation is correct, as the Court is convinced that, as between Mr. Benskin and Mrs. Poston, Mr. Benskin accepted Mrs. Poston's money with a fiduciary obligation to invest it for her. The fact is, however, he did not do that and he exercised control over the funds, commingling and then depleting them. Thereafter, the bankruptcy estate was created and Mrs. Poston became a creditor competing with other similarly defrauded creditors in the bankruptcy estate.

In summary, when the loss of the integrity of the funds is coupled with the position that Mrs. Poston bears in relationship to the other unsecured creditors, in the balance the Trustee prevails over Mrs. Poston, who will hold an unsecured claim in the bankruptcy estate. This analysis is consistent with analyses by two recent appellate courts.

The Court of Appeals for the Eleventh Circuit recently has considered a Ponzi-type scheme in Securities and Exchange Commission v. Elliott, et al, 953 F. 2d 1560 (11th Cir. 1992), rev'd in part, 998 F. 2d 922 (11th Cir. 1993), where the defendant "devised several programs as vehicles for the victims to 'invest' in his companies." Id. at 1565. In a case involving a nonbankruptcy receiver, that Court reviewed tracing concepts and in rejecting tracing for one "victim," concluded that "it would not be equitable to give some [former defrauded security holders, who occupied the same legal position as all such creditors,] preferential treatment in equity." Id. at 1570 (citing Commodity

Futures Trading Commission v. Franklin, 652 F.Supp. 163 (W.D. Va. 1986), rev'd. Anderson v. Stephens, 875 F. 2d 76 (4th Cir. 1989)). However, the same Court, in discussing the setoff claims of another creditor who was permitted to use the debtor's fraud as a defense to the receiver's claim, recognized that the facts usually drive the result.

> A claimant is not treated better in the eyes of the law if the controlling facts surrounding his or her case lead to a different legal conclusion. To argue that all claimants should be treated similarly, without presenting facts, is an empty argument. One of the basic purposes of law and the courts is to determine which facts are legally relevant or irrelevant. If relevant facts differ, then the law will treat the claimants differently. Thus, it is incorrect to say the law prefers one claimant if that claimant's situation differs in a legally cognizable way. The court must examine [each creditor's] case individually to determine what type of treatment the law should accord him.

Id. at 1573 (citations omitted).

A significant distinction made by the Elliott Court, after its examination of all of the proof, was that some

> claimants were not permitted to trace into the receivership because they were all defrauded in the same way, and the remaining funds were insufficient to cover their claims. The other claimants were not permitted to use fraud as a sword to trace assets when the assets were dissipated, while [the setoff claimant] is using fraud as a shield [to the receiver's suit against that setoff claimant].

Id. at 1574.

As instructed by the Elliott decision, this Court has examined and weighed all relevant facts in reaching its decision. There is a difference in this case between the Trustee recovering and/or retaining property of the estate, albeit originally fraudulently obtained by the debtor, and the Trustee using the debtor's fraud as a basis to sue a creditor who was defrauded by the debtor. The Maples were not the victims of the debtor's fraud; rather, they profited from the debtor's fraud. There is no equitable defense available to prevent the Trustee's recovery from them. In contrast, Beverly Poston was defrauded by the debtor and lost her investment as a result. However, Beverly Poston unfortunately is in the same position as numerous other defrauded investors. Counsel for Beverly Poston argued that Elliott was factually distinguished on the basis that its victims willingly loaned stock to the debtor; nevertheless, the victims were defrauded. Beverly Poston willingly turned her money over to this debtor and she was defrauded. The attempted distinction does not persuade the Court.

In McLemore v. Third National Bank in Nashville (In re Montgomery), 983 F. 2d 1389 (6th Cir. 1993), the Court concluded that the debtor's massive check kiting scheme involved transfers of the debtor's interest in property that depleted the debtor's estate. Notwithstanding the illegal nature of the kiting, that debtor acquired an interest in the account balance created by kiting. A critical factor was that the funds were not segregated or held in "constructive trust for the victimized institutions." Id. at 1393. In contrast to the Benskin case there was no contention in Montgomery that a trust arose. The Montgomery Court concluded that the debtor's control over the nonearmarked proceeds of the kiting was crucial to the analysis. Id. at 1395. In this proceeding, the Poston estate has not relied on an

earmarking theory. The facts would not support such a theory, as the Poston funds were depleted before the bankruptcy filing and they were not used for investment on behalf of Beverly Poston.

In its analysis, the Montgomery Court stated that "[p]reservation of the separate identity of the funds would have been of critical importance" in a case involving a victim's attempted recovery of converted, embezzled or otherwise fraudulently obtained funds. Id. at 1393. This conclusion is consistent with this Court's conclusion in this proceeding.

## CONCLUSION

The Trustee has established that the transfers to the Maples are avoidable under 11 U.S.C. §548, and a separate order and judgment will be entered in favor of the Trustee against Ray and Brenda Maples, jointly and severally, for $53,100.00 plus prejudgment interest at the federal rate from the date of filing of the Trustee's complaint.

The avoidance action and complaint by Beverly Poston against the Maples will be denied, and the recovery by the Beverly Poston estate against the bankruptcy estate will be denied, except that Beverly Poston is allowed an unsecured claim in this bankruptcy estate, with the amount of the claim to be determined in a separate hearing if necessary. See F.R.B.P. 3002(c)(3). As between the causes of action asserted by the Trustee and Beverly Poston, the Trustee's avoidance powers defeat the sole creditor's avoidance powers.

The Court will enter a separate order and judgment.

DATED this 7th day of December, 1991.

WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

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IN RE:

MARK BENSKIN & CO., INC.,

Chapter 7 (Involuntary)
Debtor.

FILED:
DECEMBER 8, 1993

BK #89-22793-B

GEORGE EMERSON, Trustee,

Plaintiff,

v.

Adversary Proceeding
No. 89-0267

DONALD and KATHERINE HOLLIE,

Defendants/Cross-Defendants,

and

DONALD RUTHERFORD,

Defendant/intervenor/
Cross-Plaintiff.

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## MEMORANDUM OPINION

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This adversary proceeding was tried on November 15, 1993, at which time the parties stipulated to numerous facts and exhibits. The Court has now received all testimony, depositions,

exhibits and the entire record in this proceeding and a final order and judgment will be entered. In this proceeding a partial settlement was reached under the terms of which the Defendants Donald and Katherine Hollie paid $60,000.00 into an escrow fund to be held jointly by the Trustee and the intervenor Donald Rutherford. See Agreed Order of Settlement entered March 16, 1993. The Hollies have been released and dismissed from this adversary proceeding as a result of that settlement. See Order Of Dismissal entered March 16, 1993. The Trustee and Donald Rutherford both look to the $60,000.00 for their recovery and each have consented to the entry of a final order by this Court, subject to the parties' rights to appeal. 28 U.S.C. §158. Moreover, the Court has determined that the issues raised involve determinations of transfer avoidance, property of the estate and allowance of claims against the estate, and, as such, they are core pursuant to 28 U.S.C. §157(b)(2)(A), (B) and (H). The jury trial demanded by the Hollies was waived by the other parties, after dismissal of the Hollies.

Counsel for the Trustee and the intervenor have been involved in other adversary proceedings in this case and are familiar with the history of his case. The Court has entered, on December 7, 1993, an amended memorandum opinion, a final order and judgment in another adversary proceeding in this case, the result of which is dispositive of this proceeding. Emerson v. Maples, et al. (In re Mark Benskin & Co., Inc., Adv.Proc. No. 91-0157 (Bankr. W.D. Tenn. Dec. 7, 1993) (hereinafter "Maples"). For purposes of judicial economy the Court adopts that Maples' opinion in full and incorporates its findings of fact, except for those that relate solely to the debtor's transactions with Beverly Poston, and its conclusions of law. A copy of that Maples' opinion will be an appendix to this opinion. For the same factual and legal reasons as found in the Maples' opinion,

the Court must decide in favor of the Trustee.

For background information, the Court specifically adopts the "History of The Case" found at pages 2-4 of the Maples' opinion. Just as was true with Beverly Poston, the debtor obtained funds from this intervenor Donald Rutherford under the false pretense of making investments for Mr. Rutherford. Unfortunately, the debtor perpetuated the fraudulent scheme of depositing Mr. Rutherford's $50,000.00 investment into the National Bank of Commerce escrow account where the funds were commingled with other customer's funds, and the debtor then used the commingled funds for payment of illusory profits to the Hollies and for payment of other checks written on the account. Mr. Rutherford's $50,000.00 credit to the escrow account was depleted prior to the filing of this bankruptcy case. See Exs. 9 & 10.

Adopting the legal conclusions and reasoning of the Court's Maples' opinion on §548(a),[1] the Court concludes that the Trustee has proven both an actual and a constructive fraudulent transfer in the amount of the $65,569.93 transfer to the Hollies on March 29, 1989. Ex. 1. The debtor's fraudulent intent is clear. See, e.g., guilty pleas and indictments, Exs. 5 & 6. Moreover, the debtor was insolvent and did not receive reasonably equivalent value for the $65,569.93 transferred to the Hollies. It was stipulated that the Hollies had invested only $4,800.00 with the debtor and that they had previously withdrawn $22,000.00. Therefore, they gave no value for their $65,569.93 withdrawal of illusory profits. The Trustee is entitled to an avoidance of that fraudulent conveyance. Had the Hollies not settled, the Trustee would be entitled to a monetary judgment

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[1] See Maples' opinion, pp. 7-11.

against them for $65,569.93 plus prejudgment interest. See, Dicello v. Jenkins, et al. (In re International Loan Network, Inc.), 24 BCD 1276 (Bankr. D.D.C. 1993). As a result of the settlement, the Trustee is entitled to a judgment against the $60,000.00 escrow account, plus its accruing interest.[2]

As to the Rutherford's claims against the $60,000.00 escrow account, his counsel again presented excellent proof on the posting method utilized in 1989 by the National Bank of Commerce, and as in the Maples' proceeding, Mr. Rutherford's proof demonstrated a tracing of the $50,000.00 Rutherford deposit into the debtor's check number 1636 issued to the Hollies. See Exs. 9 & 10; affidavits of Jim Lindsey and Jerry Whitehorn. However, adopting the reasoning of the Maples' opinion at its pages 11-23, the Court again concludes that the bankruptcy Trustee's avoidance power is superior to the state law remedies avoidable to the intervenor.

The Court will assume that a constructive trust was created when Mr. Rutherford deposited his $50,000.00 with instructions for investment on his behalf. Unfortunately, the debtor exercised control over that deposit, commingling and dissipating all of the funds. The debtor did not invest Mr. Rutherford's funds. As the Court discussed in the Maples' opinion, there was no perpetuated trust res. At the time of the bankruptcy filing the debtor's estates had an avoidance action against the Hollies, which action vested in the bankruptcy Trustee. The Trustee's §548 avoidance power is superior to Mr.

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[2] At the end of the Trustee's proof, the Court granted Mr. Rutherford's motion that the Trustee had not proven a preferential transfer. As there was no antecedent debt owed to the Hollies, §547(b)(2) could not be satisfied.

Rutherford's claims against the $60,000.00 escrow fund.[3] Mr. Rutherford is in the same position as Beverly Poston and other similarly defrauded unsecured creditors.

## CONCLUSION

In summary, based upon the reasoning and legal conclusions of this Court's Maples' opinion (Appendix to this opinion) and upon the particular facts found in this adversary proceeding, the Trustee's federal fraudulent conveyance action is sustained[4] and is superior to the state law, nonbankruptcy creditor's rights and remedies of Donald Rutherford. A separate order and judgment will be entered.

SO ORDERED this 8th day of December, 1993

WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE

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[3] While of little consolation to Mr. Rutherford, the Court notes that Mr. Rutherford testified that he had previously withdrawn $15,000.00 from the debtor, but apparently no avoidance action was filed by the Trustee against Mr. Rutherford.

[4] See generally, In re International Loan Network, Inc., 24 BCD 1276, an opinion read by this Court subsequent to entry of its Maples' opinion. The Loan Network opinion discusses the trustee's fraudulent conveyance avoidance of Ponzi scheme transfers.

**UNITED STATES BANKRUPTCY COURT**
**WESTERN DISTRICT OF TENNESSEE**
**WESTERN DIVISION**

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IN RE: FILED: JULY 10, 1992

MARK BENSKIN & CO., INC.

BK #89-22793-B (mjn)

Chapter 7 (Inv.)
Debtor

GEORGE EMERSON, Chapter 7 Trustee

Plaintiff

v. Adversary Proceeding
No. 89-0267

DONALD AND KATHERINE HOLLIE

Defendants/Cross-Defendants,

and

DONALD RUTHERFORD,

Defendant/Intervenor/
Cross-Plaintiff.

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**MEMORANDUM OPINION AND PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW ON CROSS MOTIONS FOR SUMMARY JUDGMENT**

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This cause is before the Court on cross motions for

summary judgment filed in this proceeding by Mr. George Emerson, the Chapter 7 Trustee ("Trustee") and plaintiff, Mr. Donald Rutherford, an intervening defendant and cross-plaintiff, and Mr. and Mrs. Donald Hollie, the defendants and cross-defendants. The Trustee seeks summary judgment against Mr. Rutherford and Mr. and Mrs. Hollie. Mr. Rutherford seeks summary judgment against the Trustee and Mr. and Mrs. Hollie. Mr. and Mrs. Hollie seek summary judgment against Mr. Rutherford and object to the Trustee's summary judgment motion.

At issue is whether the Trustee, as a matter of law, may avoid a prepetition transfer made by the debtor to the Hollies and recover the total amount thereof as property of the estate or whether Mr. Rutherford, as a matter of law, is entitled to recover the bulk of the funds transferred as "trust" funds. Both motions are part of a core proceeding under 28 U.S.C. §157(b)(2)(F) and (H). Because the Trustee's motion concerning the preferential transfer and the cross motions filed in response thereto involve questions regarding property of the estate, they are core pursuant to 28 U.S.C. §157(b)(2)(A), (B), (F) and (O). Therefore, resolution of these preference issues constitutes findings of fact and conclusions of law pursuant to F.R.B.P. 7052 and 7056. However, the dispute between Mr. Rutherford and the Hollies, to the extent it may involve questions concerning non-estate property, is non-core but its resolution may affect the adjustment of the debtor-creditor relationship and the allowance of claims against the estate and it is, thus, "otherwise related" to the Chapter 7 case of Mark Benskin & Co., Inc. 28 U.S.C. §157(b)(3), (c)(1). As such, the portion of this opinion regarding resolution of this latter dispute constitutes proposed findings of fact and conclusions of law to be submitted to the United States District Court for the Western District of Tennessee for de novo

review and entry of a final order and judgment. 28 U.S.C. §157(c)(1).[1]

The record in this proceeding reflects that it was commenced with the filing of the Trustee's complaint on September 22, 1989, against Donald and Katherine Hollie seeking to recover under 11 U.S.C. §§547 and 548 an alleged avoidable transfer of $65,569.53 made by the debtor to the Hollies on March 29, 1989. Subsequently, Mr. Rutherford was allowed to intervene by consent order pursuant to his motion filed on November 22, 1989.

It is Mr. Rutherford's position that on March 28, 1989, he delivered a $50,000.00 check to the debtor for investment purposes but that the debtor wrongfully used his investment to make the bulk of the $65,569.53 transfer to the Hollies. Accordingly, Mr. Rutherford contends that the funds, to the extent of his $50,000.00 deposit, were "trust" funds that never became property of the debtor's estate and that he is entitled to recover that amount from the Hollies. Not surprisingly, the Trustee takes issue with Mr. Rutherford's position and asserts that any funds he deposited with the debtor became property of the debtor's estate. Therefore, according to the Trustee, any funds subsequently transferred to the Hollies are subject to recovery for the benefit of the bankruptcy estate as preferential

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[1] The Court notes that it concluded in an earlier adversary proceeding that a constructive trust was established as a part of a core proceeding. In re Mark Benskin & Co., Inc., 135 B.R. 825, 832 (Bankr. W.D. Tenn. 1991). However, there the parties had "treated th[e] entire trial as a core proceeding . . . ." Id. Here, there is no consent to this Court entering a final order. In fact, the Hollies object to this being a core proceeding and they resist this Court's subject matter jurisdiction. "This Court is cautious about construing its core jurisdiction too broadly," especially in the presence of the Hollies' lack of consent. Id.

or fraudulent conveyances.[2] In response to both assertions, the Hollies contend that neither the Trustee nor Mr. Rutherford is entitled to recovery of the transfer complained of as it was a return of their earlier investment with the debtor that rightfully belongs to them.

## FACTUAL SUMMARY

The debtor's Chapter 7 case was commenced with the filing of an involuntary petition on April 14, 1989. Prior to that time, the debtor was operated as a sole proprietorship by Mr. Mark Benskin who acted as an unlicensed investment advisor. Mr. Benskin is also an involuntary Chapter 7 debtor in this Court in case number 89-23263-B. See, In re Mark Benskin & Co., Inc., 135 B.R. 825, 827 (Bankr. W.D. Tenn. 1991) (Findings of Fact No.'s 1 and 2). Investors would open "investment accounts" with Benskin and/or his company. The "investment accounts" were usually opened with checks made payable to Mark Benskin & Co., Inc., and Benskin deposited and commingled those checks in a client "escrow fund" account. From that account, Benskin withdrew or transferred funds for operating expenses and some personal expenses. Id.; see also, Benskin deposition, July 26, 1991, pp. 45 and 52-53. Meanwhile, Benskin would issue fictitious investment account statements to these investors falsely reflecting that their funds had been legitimately invested. See, e.g., Benskin deposition, July 26, 1991, Ex.'s 4, 7, and 10. According to Benskin, beginning in January 1989, he transferred newly deposited investment funds from new investors to earlier investors as fictitious earnings on their "investments." Benskin deposition, July 26, 1991, pp. 61-64.

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[2] The Trustee does not rely upon his fraudulent conveyance theory for purposes of the instant motion. Summary judgment is sought as to the preferential transfer allegations only.

As a result of these Ponzi scheme activities, Benskin "turned himself in" to the Federal Bureau of Investigation on April 16, 1989. Benskin deposition, July 26, 1991, pp. 32, 44, 46. He subsequently entered guilty pleas in response to criminal indictments in the United States District Court for the Western District of Tennessee and the Criminal Court for Tennessee's Thirtieth Judicial District at Memphis. He is presently serving a sentence in a federal correctional facility located at Millington, Tennessee. U.S. v. Benskin, 926 F. 2d 562 (6th Cir. 1991); In re Mark Benskin & Co., Inc., 135 B.R. at 827 (Finding of Fact No. 1): Ex.'s 9 and 11 to Donald Rutherford's Second Motion for Summary Judgment.

As noted above, following his arrest, involuntary Chapter 7 petitions were filed against Benskin and his company. Orders for relief were entered on June 12, 1989, and Mr. Emerson was appointed Trustee in both cases. Pursuant to his investigation, the Trustee filed this and other avoidance actions seeking to recover funds transferred by the debtor prepetition as property of the estate. The Court subsequently determined, in a bifurcated insolvency trial, that both debtors were insolvent for the year preceding the bankruptcy filings. In re Mark Benskin & Co., Inc., 135 B.R. at 829 (Findings of Fact No. 22). However, that insolvency finding is not binding upon defendants, such as the Hollies, who demanded a jury trial. See Order, October 2, 1990, entered in this proceeding on November 20, 1990.

Relative to the issues in this proceeding, the Court has previously made certain findings of fact in its January 25, 1991, order denying Mr. Rutherford's first motion for summary judgment. These findings[3] are incorporated herein by reference.

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[3] It should be noted that the Benskin deposition referenced in the Court's earlier findings was taken on April 17, 1990.

Mr. Rutherford's first motion for summary judgment was denied because the Court concluded that: (1) there had been no demonstration, beyond genuine dispute, that an express trust was created in favor of Mr. Rutherford; (2) the facts presented did not demonstrate an absence of genuine dispute over the application of constructive trust concepts; (3) there existed a genuine factual dispute as to whether a bailment could have been created; and (4) it would be necessary to hear all of the disputed facts at trial before determining whether tracing was appropriate and, if so, which test for tracing, i.e., "first in-first out" or "lowest intermediate balance," was appropriate.

Following entry of the above described unpublished memorandum opinion and order, Mr. Rutherford filed the present, his second, motion for summary judgment accompanied with the December 27, 1991, affidavit of Jerry Whitehorn, a licensed certified public accountant specializing in the field of bank auditing and accounting; the July 26, 1991, deposition of Mark Benskin; and fourteen additional exhibits to be discussed below, all intended to support Mr. Rutherford's second motion. Subsequently, the Trustee filed his cross motion against Mr. Rutherford and the Hollies and the Hollies filed their motion for summary judgment against Mr. Rutherford. The exhibits, affidavits and depositions submitted and relied upon by the parties for purposes of the instant controversy evidence the following facts which confirm or supplement those previously adduced.

Benskin's deposition testimony of July 26, 1991, clearly establishes that on March 28, 1989, he obtained a $50,000.00 check made payable to Mark Benskin and Company from Mr. Rutherford through fraud and false pretenses. Benskin deposition, July 26, 1991, p. 32. It further establishes that new investor deposits, such as Mr. Rutherford's, were being used to

pay earlier clients for their purported but false investment earnings. Id. at p. 77. Although Benskin states that Mr. Rutherford gave him no instructions regarding the investment of his funds, it is obvious that Benskin knew that Mr. Rutherford intended for them to be invested. Id. at pp. 3033. Benskin's denial of any instruction from Mr. Rutherford is belied by Mr. Rutherford's affidavit and the fictitious statements issued by Benskin to Rutherford, which falsely indicated investment of his funds in the American Capital Government Securities Fund and American Capital Common Stock Fund. See, Ex's. 2 and 6 to Donald Rutherford's Second Motion for Summary Judgment.

Furthermore, additional exhibits submitted by Mr. Rutherford in connection with this motion establish that Mr. Rutherford's funds were deposited into the Benskin Company escrow account on March 28, 1989. Ex. 3 to Donald Rutherford's Second Motion for Summary Judgment. The unrefuted affidavits of Mr. Jim Lindsey, an auditor with the National Bank of Commerce ("NBC") where Benskin's account was located, and Mr. Jerry Whitehorn establish that but for this deposit of Mr. Rutherford's check, the $65,569.63 check issued to the Hollies would not have been honored on March 30, 1989. Ex. 7 to Donald Rutherford's Second Motion for Summary Judgment; Affidavit of Jerry Whitehorn. Moreover, Mr. Lindsey's affidavit establishes that NBC debited its depositors' accounts, including Benskin's, by paying the smallest checks presented for payment first and the largest last. Ex. 7 to Donald Rutherford's Second Motion for Summary Judgment. Mr. Whitehorn's affidavit states that "the only logical and precise methodology to trace the establishment and pay out of the credits posted to the [Benskin] escrow account" is the "first in - first out" rule meaning that the first credits posted to the account are the first paid out. Affidavit of Jerry Whitehorn, ¶'s 8 and 9. Based on this methodology the

Rutherford deposit was used to pay the check to the Hollies, according to Mr. Whitehorn. Id. at ¶'s 9-12. Exhibit A to Mr. Whitehorn's affidavit demonstrates that paying the smallest debit first and using the first in - first out accounting method, the debtor's credits of $95,264.19 on March 27, 1989, were depleted by the payment of debits on March 29, 1989; the debtor's $71,200.00 deposit (including Mr. Rutherford's $50,000.00) on March 28, 1989 was depleted by the payment first of check number 1613 for $911.70 on March 29; second of check number 1625 for $13532.00 on March 30; and third of check number 1636 for $56,756.30 issued to the Hollies on March 30. The balance of the Hollies' check, $8,813.23, was paid from a $22,000.00 deposit made by the debtor on March 29, 1989. This same series of transactions is reflected in the charts and graphs marked as collective Exhibit 14 to Mr. Rutherford's Second Motion for Summary Judgment. According to Mr. Whitehorn, Exhibit 14 presents "accurate graphical representations and summaries of the posting of the debits and credits to the ... escrow account at ... [NBC] between March 28, 1989 and March 30, 1989." Affidavit of Jerry Whitehorn, ¶17.

No contradictory proof with respect to these affidavits has been presented by either the Trustee or the Hollies. Therefore, from this evidence, the Court can find without a doubt that, as a matter of fact, Rutherford's funds were acquired by the debtor through prepetition fraud and that Rutherford has adequately traced these funds into and out of the debtor's escrow account to the Hollies using the "first in - first out" method. This method is the only one on which proof, as opposed to argument has been offered.

Rather than offer contradictory proof, both the Trustee and the Hollies contend that for purposes of the dispute here, applicable law precludes Mr. Rutherford from recovery of the

funds paid to the Hollies to the extent of his deposit with Benskin. As noted above, it is the Trustee's position that these funds are recoverable as the subject of an avoidable transfer of property of the estate. According to the Trustee, under applicable law, Mr. Rutherford has not established the creation of an express trust with regard to the funds in Mr. Rutherford's favor, and the imposition of a constructive trust is inappropriate given that the funds were no longer in Benskin's account at commencement of the bankruptcy case. The Hollies echo the Trustee's argument in opposition to the creation of an express trust and imposition of a constructive trust. They further contend that even if impressed with a constructive trust upon Benskin's acquisition, the funds are not recoverable by Mr. Rutherford because they were paid to the Hollies as good faith purchasers for value. In response to the Trustee's preference action, the Hollies assert that the funds do not qualify as the subject of a preferential transfer in that they consist of profits on their initial investment rather than a return of that specific investment or payment of an antecedent debt.[4]

## SUMMARY JUDGMENT

Summary judgment is available for a moving party only when after consideration of the evidence presented by the pleadings, affidavits, answers to interrogatories, and depositions in a light most favorable to the non-moving party, there remain

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[4] Among the Court's prior findings that have been incorporated by reference are the facts that:

> Mr. Hollie initially 'invested' $4,800.00 with the debtor in 1986. Without further investment, Mr. Hollie withdrew approximately $87,000.00, including the $65,569.53 withdrawal in March, 1989. (Donald Hollie deposition, 7).

Memorandum...on Donald Rutherford's Motion for Summary Judgment, January 25, 1991 (Finding of Fact No. 7).

no genuine issues of material fact. F.R.B.P. 7056(c). Consequently, "[t]he mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact." Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 106 S. Ct. 2505, 2511, 91 L. Ed.2d 202 (1986); Street v. J.C. Bradford & Co., 886 F.2d 1472 (6th Cir. 1989). Whether a fact is material is to be determined by the substantive law. Street v. J.C. Bradford, 886 F. 2d at 1480.

As set forth above, the transactions which give rise to the motions at issue are not factually in dispute here; rather, the legal effect of these transactions is in dispute.

NON-CORE PORTION OF PROCEEDING; PROPERTY OF THE ESTATE OR "TRUST" PROPERTY?

The viability of the Trustee's claim to the funds that Mr. Rutherford asserts are trust funds is dependent upon whether these funds amount to "an interest of the debtor in property." 11 U.S.C. §547(b); §548(a). Thus, essential to resolution of the issues presented here is a determination of whether the funds in dispute qualify as property of the bankruptcy estate. Fundamental to this determination is an examination of the nature and extent of the debtor's prepetition interest in the funds. Section 541 (a) of the Bankruptcy Code designates any legal or equitable interests of the debtor in property at commencement of the bankruptcy case "property of the estate" and that includes any interests recovered pursuant to applicable avoidance sections of the Code. 11 U.S.C. §541 (a)(1) and (3). This is an "admittedly broad definition of includable property," however, the nature and extent of the debtor's interests referenced by §541(a) are determined by state law applied in a manner consistent with federal bankruptcy law. Patterson v. Shumate, ___ U.S.___, 112 S. Ct. 2242, 2249 (1992); In re North American Coin & Cur-

rency, Ltd., 767 F.2d 1573 (9th Cir. 1985), am'd. 774 F. 2d 1390 (9th Cir. 1985); In re Howard's Appliance Corp, 874 F. 2d 88, 93 (2nd Cir. 1989); In re White, 851 F.2d 170, 173 (6th Cir. 1988). The filing of the bankruptcy petition does not expand the debtor's property interests; the estate succeeds to property only to the extent of the right and title possessed by the prepetition debtor. United States v. Whiting Pools, 462 U.S. 198, 204, n. 8, 103 S. Ct. 2309, 2313 n. 8, 76 L. Ed.2d 515 (1983). This rule is significant here because it is generally held, pursuant to 11 U.S.C. §541 (d), where a debtor holds property in trust for another, that the debtor's only interest is mere legal title.[5] Id. Moreover, in the bankruptcy context, the claim of the equitable interest holder or beneficiary to trust assets is considered superior to that of the bankruptcy trustee notwithstanding the trustee's judgment lien creditor status or avoidance powers. See, e.g., In re Quality Holstein Leasing, 752 F. 2d 1009, 1012 (5th Cir. 1985); In re Howard's Appliance Co., 874 F. 2d 88 at 93. Indeed, the United States Supreme Court has noted that under Bankruptcy Code §541(d), the bankruptcy estate "plainly" does not include "property of others held by the debtor in trust at the time of the filing of the petition." United States v. Whiting Pools, 103 S. Ct. at 2313, n. 10.

Similarly, under both state law and federal bankruptcy law, the equitable interest in property acquired by fraud remains property of its rightful owner to the extent that it is identifiable. See, e.g., Quality Holstein Leasing, 752 F. 2d at 1012; In re Anderson, 30 B.R. 995 (M.D. Tenn. 1983); Covert v. Nashville,

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[5] Section 541(d) provides in pertinent part: "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest.... becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

C & St. L. Ry., 186 Tenn. 142, 208 S.W. 2d 1008, 1 A.L.R. 2d 154 (1948). Accordingly, the fraudulent acquirer obtains mere title or a possessory interest and is said to hold the property in trust for its beneficiary or rightful owner. Such a trust is "constructed" by a court of equity "to satisfy the demands of justice" and prevent unjust enrichment. In re Anderson, 30 B.R. at 1014. Thus, it is referred to as a "constructive trust." Id. In addition to the general trust requirements of a trustee, a beneficiary, and identifiable trust property, a constructive trust requires proof of: "(1) a wrongful act; (2) specific property acquired by the wrongdoer which is traceable to the wrongful behavior; and (3) an equitable reason why the party holding the property should not be allowed to keep it." In re Independent Clearing House Co., 41 B.R. 985, 1000 (Bankr. D.Utah 1984) (citations omitted), on appeal 62 B.R. 118 (D. Utah 1986). See also In re Mark Benskin & Co., 135 B.R. at 833, citing Kopsombut-Myint Buddhist Center v. State Board of Equalization, 728 S.W. 2d 327, 333 (Tenn. App. 1986). The §541(d) exclusion from property of the estate applies with equal force to constructive and express trusts. See, e.g., In re Howard's Appliance, 874 F. 2d at 93. Given these precepts, the issue becomes whether Mr. Rutherford has sufficiently demonstrated the existence of a constructive or an express trust with respect to his deposit.

Turning first to the question of a constructive trust, it is well settled that the burden of proving facts which warrant the imposition of a constructive trust and thus, application of §541(d), is on the claimant. First Federal of Michigan v. Barrow, 878 F.2d 912, 915 (6th Cir. 1989). If it can be demonstrated that the subject property was acquired by fraud, the claimant must then demonstrate that it can be traced. Id. at 915-916. In the bankruptcy context, sufficient tracing and identification of the

trust property is essential to the establishment of a constructive trust when the funds have been commingled with other funds. According to the Sixth Circuit Court of Appeals,

> ... the predicate for the trust doctrine as applied in bankruptcy is a perpetuated integrity of the trust properties so as to avoid conflict with and between creditor classes; ... If the trust fund or property cannot be identified in its original or substituted form, the cestui que trust becomes merely a general creditor of the estate.

First Federal of Michigan v. Barrow, 878 F. 2d at 915 (Emphasis added). Whether property has been sufficiently traced is a factual determination. In re General Coffee Corp., 64 B.R. 702, 709, n. 13 (S.D. Fla. 1986), affd at 828 F. 2d 699 (11th Cir. 1987). The first in - first out tracing method is accepted in Tennessee, at least outside of the bankruptcy context. In re Mark Benskin & Co., 135 B.R. at 833, State ex rel. Robertson v. Bank of Bristol, 165 Tenn. 461, 55 S.W. 2d 771 (1933); State ex rel. Robertson v. Thomas W. Wrenne & Co., 170 Tenn. 131, 92 S.W. 2d 416 (1936); see also Tenn. Code Ann., §47-4-208.

In the proceeding at bar it is undisputed that the debtor obtained Mr. Rutherford's funds by fraud. It is further clearly established from the unrefuted testimony of a bank official and an auditor that using the first in - first out method of account analysis, the Rutherford funds were used for $50,000.00 of the $65,569.53 paid to the Hollies of which approximately $40,000.00 is invested in a certificate of deposit.[6] Finally, it is uncontroverted here that the Hollies received a cumulative "return" of approximately $87,000.00 between 1986 and 1989 on their initial, single investment of $4,800.00. Thus, excluding the

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[6] See Memorandum ... Order .... January 25, 1991 (Finding of Fact No. 8).

$50,000.00 at issue here, the Hollies received approximately $32,200.00 in addition to the return of their investment from the debtor. These facts simply do not support the Hollies' contention that they were paid these funds "for value."[7] Moreover, from these facts, the Court can find at least two equitable reasons why the Hollies should not be permitted to retain the $50,000.00 at issue. First, from all the evidence presented, it is unquestionable that $50,000 of the $65,569.53 paid to the Hollies are in fact Mr. Rutherford's funds rather than earnings on any money the Hollies invested. There was no separate investment account established for the Hollies from which these funds were paid. These funds were paid to the Hollies in accordance with the debtor's Ponzi scheme! Second, to allow retention of these funds by the Hollies would result in such unjust enrichment that the Court is unable to believe that the Hollies can make their argument in good faith. For the Hollies to retain such an exorbitant "profit" at the expense of Mr. Rutherford would be shocking to any court of equity. Clearly, the elements necessary for imposition of a constructive trust in favor of Mr. Rutherford under both state law and federal bankruptcy law, as discussed above, are depicted here.

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[7] The Hollies contend that a genuine issue of material fact exists on this issue in that the debtor's "use," of their $4,800.00 constitutes value. However, they have advanced no evidence to support the proposition that their single $4,800.00 deposit constitutes value given in exchange for the $65,569.53 payment at issue here. To the contrary, Mr. Hollie has testified that they "invested" no additional funds or other assets with the debtor and received a prior distribution from the debtor which, when added to this payment, results in a total return of approximately $87,000.00 on this $4,800.00. Donald Hollie Deposition, April 11, 1990, pp. 6-7. Thus, the payment at issue cannot be said to include a return of their initial investment. Absent evidence of the value, if any, given in exchange for this payment in the face of Mr. Rutherford's tracing, the Court is not persuaded that a genuine issue of material fact exists. Anderson v. Liberty Lobby Inc., 106 S. Ct. at 2511.

However, the Trustee and the Hollies contend that the imposition of a constructive trust is impermissible here because the funds were no longer in the debtor's possession at the commencement of the case. Thus, the funds had been dissipated and were no longer traceable according to these parties. Further, according to the Trustee and the Hollies, these circumstances trigger application of the "lowest intermediate balance test" set forth in the Sixth Circuit Court of Appeals' Barrow opinion cited above. It is this Court's understanding that the "intermediate balance test" is applicable in situations where a claimant is urging the imposition of a constructive trust upon funds, on deposit in a general bank account of the debtor, that have been deposited since dissipation of the original alleged "trust fund" deposit or upon alleged "trust funds" that have been reduced at commencement of the bankruptcy case to an amount less than the original "trust fund." In a case where the funds have been so reduced, the alleged "trust fund" "must be regarded as dissipated except as to the balance, and funds subsequently added from other sources cannot be subject to the equitable claim of the cestui que trust" First Federal of Michigan v. Barrow, 878 F. 2d at 916. However, if new money is deposited before the reduction, the reduction "should be considered to be from the new money and not from the monies held in trust. This analysis may be referred to as the lowest intermediate balance test." Id.

It is the position of the Trustee and the Hollies that this test precludes application of the first in - first out method of analyzing the debtor's account transactions. However, the lowest intermediate balance legal test is distinguishable from the first in - first out factual method of account analysis. Because there were in fact no funds in the debtor's possession at commencement of the case, the argument that the lowest intermediate balance test is applicable might have merit were Mr.

Rutherford attempting to recover the amount of his deposit from anonymous funds recovered for the estate postpetition by the Trustee. Cf. In re First Capital Mortgage Loan Corp., 917 F. 2d 424, 429 (10th Cir. 1990) ("The issue in this case is. . . . the character of the funds once they are recovered as preferential payments.") (Emphasis in original). In addition, had Mr. Rutherford been unsuccessful as a matter of fact in tracing his deposit beyond the debtor's commingled escrow account, he would be precluded from asserting an interest in the funds paid to the Hollies. Under those circumstances, there would be no identifiable, specific trust property against which he could assert his claim and thus, no "perpetuated integrity of trust properties." First Federal of Michigan v. Barrow, 878 F. 2d at 915. Contrary to such a scenario and unlike the trust beneficiary claimants in the authorities cited by the Trustee and the Hollies, where the claimants were unable to trace beyond the debtor's account, Mr. Rutherford has succeeded here, without contradiction, in identifying and tracing his deposit in its original and "substituted form" into, through, and out of the debtor's escrow account to the Hollies' certificate of deposit. Id. Indeed, the critical distinction between this case and, for example, the Barrow case, is that rather than pursuing anonymous funds possessed by the Trustee, Mr. Rutherford is pursuing funds identified and traced to the debtor's prepetition payee. Under these circumstances, the reliance of the Trustee and the Hollies on the "lowest intermediate balance test" espoused by the Barrow Court is misplaced. The "lowest intermediate balance test" clearly is applicable only in the absence of tracing or identification of the claimed trust funds into and beyond the debtor's commingled account. First Federal of Michigan v. Barrow, 878 F. 2d at 916.

This case is likewise distinguishable from, for example, the Independent Clearing House and Tinnell Traffic Services

cases in that Mr. Rutherford is not attempting to retain funds of uncertain origin paid to him prepetition by the debtor.[8]

Cases involving asserted constructive trust fund claimants who could not factually trace their claimed funds beyond the debtor's possession simply do not support the proposition that such claimants may not a legally trace their claimed funds. See, e.g., First Federal of Michigan v. Barrow, 878 F. 2d 912; In re Independent Clearing House Co., 41 B.R. 985; Cunningham v. Brown, 265 U.S. 1, 44 S. Ct. 424 (1924). To the contrary, these cases demonstrate the availability of constructive trusts in the bankruptcy context if the factual tracing requirements can be satisfied. See e.g., In re Johnson, 960 F. 2d 396 (4th Cir. 1992). Consequently, the Court is not persuaded that Mr. Rutherford is legally precluded from tracing his funds to the Hollies using the first in - first out method when he has in fact done so.

Given these findings and conclusions, it is evident that the elements necessary for imposition of a constructive trust are present here. As discussed above, such an imposition may be accomplished by a court of equity to avoid a "blatant and manifest injustice." In re Anderson, 30 B.R. at 1013. This Court, sitting as a court of equity, is convinced that to deny Mr. Rutherford recovery of the funds he has traced to the Hollies would result in a "blatant and manifest injustice" and would permit unjust enrichment. Id. Therefore, although the imposition of a constructive trust had not been ordered by a court of equity at the time of the debtor's transfer to the Hollies, this Court is satisfied that the above factual findings warrant such an order. Cf., In re Tinnell Traffic Services, Inc., 41 B.R. at 1021.

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[8] In re Independent Clearing House Co., 41 B.R. 985 (Bankr. D. Utah 1984), on appeal 62 B.R. 118 (D. Utah 1986); In re Tinnell Traffic Services, Inc., 41 B.R. 1018 (Bankr. M.D. Tenn. 1984).

Accordingly, the Court concludes that to the extent that Mr. Rutherford's $50,000.00 deposit has been traced to the funds remaining with the Hollies, they are impressed with a constructive trust in Mr. Rutherford's favor and he is entitled to recovery from the Hollies. The Court understands the proof to establish that the Hollies still hold $40,000.00 of Mr. Rutherford's funds in a certificate of deposit, which certificate, with its accrued interest, is impressed with a constructive trust in favor of Mr. Rutherford. In this non-core phase of this proceeding, the Court is making proposed findings and conclusions pursuant to 28 U.S.C. §157(c)(1), and the Court will recommend a judgment for a constructive trust in favor of Mr. Rutherford against the Hollie's certificate of deposit plus its accrued interest. The Court can not recommend a judgment for the full $50,000.00 because Mr Rutherford has traced only to the certificate of deposit. The Court notes that the Hollies have spent some of the $50,000.00, including payment of tax liabilities. The Hollies may have a claim for refund of taxes due to the fictional nature of their investment profit. Nevertheless, in the absence of tracing to the Hollies' transferees and in the absence of proof that those were not good faith transferees for value, the Court is unable to recommend a judgment against the Hollies except to the extent of the certificate of deposit. This conclusion of course renders the traced funds excluded from the bankruptcy estate and extinguishes the necessity to consider whether Mr. Rutherford's deposit may have been the subject of an oral, express trust or a bailment.

**CORE PORTION OF PROCEEDING**

Having thus resolved the issues concerning the bulk of Mr. Rutherford's deposit in Mr. Rutherford's favor, the issue becomes whether the balance of the funds paid to the Hollies by the debtor in this same transaction are subject to recovery by the

Trustee as the subject of a preferential transfer as a matter of law. The preference phase of this opinion is a core proceeding. 28 U.S.C. §157(b)(2)(F).

In order to avoid a transfer as preferential the Trustee must demonstrate that the transfer was:

> ...of an interest of the debtor in property -
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made -
>
> (A) on or within 90 days before the date of the filing of the petition; . . .
>
> (5) that enables such creditor to receive more than such creditor would receive if -
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. §547(b).

As discussed above, the bankruptcy estate generally includes all legal and equitable interests of the debtor in property at commencement of the case. 11 U.S.C. §541(a). Other than the Hollies' asserted claim to the $15,569.93 balance at issue

here, which they have not traced to their initial "investment," there are no specific claims to these funds. Given the absence of evidence to the contrary it may be concluded that the debtor possessed both legal and equitable interests in the balance of these funds and they became property of the estate upon the filing of the bankruptcy petition, In re Quality Holstein Leasing, Inc., 752 F. 2d at 1012. It is undisputed that the transfer was made within 90 days before the filing of the petition. Whether the debtor was insolvent when the transfer was made is an issue on which no proof has been offered in the adversary proceedings where jury trials have been demanded. The Hollies demanded a jury trial.[9] Consequently, for this reason alone, the Trustee's motion for summary judgment on his preference complaint may be denied. However, assuming arguendo that insolvency is no longer an issue, the question next becomes, under §547(b), whether the transfer was made on account of "an antecedent debt" to the Hollies as "creditors."

The unrefuted facts and circumstances surrounding the debtor's transfer of these funds to the Hollies are set forth above and in the Court's first Memorandum and Order in this proceeding issued on January 25, 1991. In essence, it is established that, although the funds transferred to the Hollies were purported to be fictional "earnings" on their 1986 investment of $4,800.00 they were in fact funds received from other sources by the debtor and deposited into the debtor's general account during the two days preceding the transfer. The evidence additionally establishes that the Hollies' initial investment of $4,800.00 had been repaid to them by the debtor

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[9] The Court has concluded a bifurcated solvency trial in the non-jury adversary proceedings but the results were not binding on defendants who demanded a jury trial.

prior to the 90 day pre-petition period.

Accordingly, although the Hollies, by a strained argument, may have been "creditors" of the debtor within the meaning of the Bankruptcy Code, there is simply no evidence that the payment at issue here was a payment "on account of antecedent debt" owed to the Hollies. See 11 U.S.C. 101(10) and (5); Matter of Cohen, 875 F. 2d 508, 509-10 (5th Cir. 1989). Thus, the Trustee's motion for summary judgment on his preference claim must be denied. To conclude otherwise would perpetuate the faulty theory that the payment of these funds to the Hollies arose out of a transaction with "economic substance" in which their initial deposit actually earned a return and that they were actually owed the money they received from this payment. Matter of Cohen, 875 F. 2d at 510-11. Had the Hollies moved for summary judgment on the preference claim, the Court would have been required to grant it.

The Court's conclusion with respect to the Trustee's preference claim does not preclude the Trustee from pursuing his §548 fraudulent conveyance cause of action against the Hollies. "Indeed, courts have ruled for trustees asserting such claims against investors in other Ponzi schemes." Id. However, as the Trustee's summary judgment motion is not founded on §548, that question is not ripe for resolution.

From the above findings and conclusions, two separate orders will be entered. One order on the core portion of this proceeding will be a final order denying the Trustee's motion for summary judgment on the preference cause of action. The other order on the non-core portion of this proceeding will recommend that the United States District Court grant Mr. Rutherford's summary judgment motion and enter a judgment for a constructive trust in favor of Mr. Rutherford against the Hollies as to the latters' certificate of deposit and its accrued interest.

This Court will further recommend that the Trustee's and the Hollies' summary judgment motions be denied as to Mr. Rutherford.

SO ORDERED, this 10th day of July, 1992.

WILLIAM HOUSTON BROWN

UNITED STATES BANKRUPTCY JUDGE